92-1586

Supreme Court, U.S.
FILED
MAR 29 1993
OFFICE OF THE CLERK

No.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1992

DEAN WITTER REYNOLDS INC.,
a corporation,

Petitioner,

v.

HUDSON T. HARRISON and HARRISON CONSTRUCTION INCORPORATED, a corporation,

Respondents.

Petition for Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

PETITION FOR WRIT OF CERTIORARI

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QUESTIONS PRESENTED

1. Whether the Seventh Circuit erred by extending—in conflict with the law of eight other Circuits—a broker-dealer's potential vicarious "control person" liability under Section 20(a) of the Securities Exchange Act of 1934 to the personal conduct of an employee for which the Court held that the broker-dealer could not be found liable, as matters of law, under common law respondeat superior, agency, or negligence principles.

2. In any event, whether a broker-dealer may be vicariously liable under Section 20(a), despite that Section's express "good faith, non-inducement" defense, for not detecting that some of the funds that an employee lost in otherwise legitimate transactions in his own employee account were borrowed from sophisticated non-customers, to whom the broker-dealer owed no legal duty, when the unauthorized, personal loan transactions constituting the underlying securities law violations:

> a) were so obviously designed to cheat the broker-dealer that, as a matter of law, no reasonably prudent person could have supposed the transactions to have involved or been authorized by the broker-dealer; and
>
> b) were successfully concealed from the broker-dealer, with the non-customers' cooperation, through the purposeful evasion of the broker-dealer's supervisory procedures.

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OPINIONS BELOW

The opinion of the United States Court of Appeals for the Seventh Circuit (App. A) is reported at 974 F.2d 873 (7th Cir. 1992). The opinion of the United States District Court for the Northern District of Illinois (App. B) is reported at 715 F. Supp. 1425 (N.D. Ill. 1989).

JURISDICTION

The judgment of the court of appeals was entered on September 8, 1992. A petition for rehearing was denied on December 28, 1992 (App. C).

The jurisdiction of this Court is invoked under 28 U.S.C. §1254(1).

STATUTE INVOLVED

The statute involved in this case is set forth in full below.

Securities Exchange Act of 1934, Section 20(a), 15 U.S.C. §78t(a):

> Every person who, directly or indirectly, controls any person liable under any provision of this title or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

STATEMENT OF THE CASE

In 1985, John Carpenter and John Kenning, two Dean Witter[1] account executives, told plaintiff Hudson Harrison, millionaire and sole owner of plaintiff Harrison Construction Incorporated ("HCI"), that they had an opportunity to make exceptionally large profits by buying municipal bonds in their personal employee accounts at substantial price and commission discounts. App. at 2, 31; C.App. 9.[2] Carpenter and Kenning also told Harrison that he could

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[1] Dean Witter Reynolds Inc., a registered broker-dealer, is a subsidiary of Sears Roebuck & Company.

[2] References to Appendix ("App.") refer to the appellate court's decision dated September 8, 1992, a copy of which is included herewith at Appendix A, pages 1-27, or to the district court's decision dated June 21, 1989, a copy of which is included herewith at Appendix B, pages 28-55; references to Cross Appendix ("C.App.") refer to the appendix filed by petitioner in the Seventh Circuit that contains the supporting portions of the Record on Appeal.

buy these same bonds as a customer of Dean Witter, but that his profits would be much smaller because customers were not entitled to the substantial employee discounts available to them. App. at 31, 40-41; C.App. 9. Carpenter and Kenning said, however, that if Harrison would loan funds to them personally, they would use the borrowed funds to take advantage of this "bond deal" and would share their large profits with Harrison by paying him exceptionally high interest rates of 18 to 60%. App. at 2, 32; C.App. 9.

Over the next 18 months, Harrison (and HCI) made approximately 20 such loans to Carpenter and Kenning, totalling approximately $4 million. App. at 2, 31-32; C.App. 15. As his only evidence of these transactions, Harrison received Carpenter's and Kenning's personal Promissory Notes.[3] Actually, Carpenter and Kenning gave Harrison two Notes for each transaction involving HCI—one which accurately stated the amount of interest Harrison expected HCI to receive and one that falsely understated the interest. App. at 2; C.App. 33. Carpenter and Kenning also supplied both Harrison and HCI with false IRS Forms 1099 that purported to reflect their receipt of substantially understated amounts of interest from Carpenter. App. at 32; C.App. 28. Harrison listed only the falsely understated amount reflected on his false Form 1099 as interest income received from "John Carpenter" on his personal 1985 federal and state income tax returns. C.App. 29.

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[3] Initially, Harrison received Notes on which Carpenter was named as the sole promisor. App. at 2; C.App. 20. Sometime in the fall of 1985, however, Harrison asked that Kenning be added as an additional promisor on all subsequent Notes. C.App. 22. Dean Witter's name does not appear on any of the Notes (or on any other documents received by Harrison or HCI), nor did Harrison ever request that it appear. App. at 32, 53; C.App. 23, 42.

In order to conceal these transactions, and to evade Dean Witter's supervisory procedures that required Carpenter's and Kenning's branch manager to review all incoming and outgoing correspondence and to intercept all incoming checks, Carpenter and Kenning instructed Harrison to (and Harrison did) make all of his and HCI's checks and wire transfers payable to Carpenter personally and mail or wire them to Carpenter's home or personal bank account. App. at 2, 30, 38; C.App. 10, 13, 18, 19, 49. No payments were ever sent to Dean Witter. App. at 53; C.App. 13. Similarly, Harrison never sent any correspondence relating to these transactions to any Dean Witter office. App. at 5, 40; C.App. 27.

During the course of the transactions, Carpenter and Kenning made approximately $1 million in "interest" and "principal" payments to Harrison, all in cash or by Carpenter's personal check. App. at 32; C.App. 24. Carpenter and Kenning, however, never purchased any municipal bonds with the funds borrowed from Harrison. Instead, they diverted all of the funds to other personal purposes, including payments to other "investors", outside investments (such as race horse breeding farms), and purchases of options in Carpenter's personal employee account.

Based upon these undisputed facts, the district court entered summary judgment in favor of Dean Witter on all counts of Harrison's complaint.[4] The Seventh Circuit

[4] Harrison's complaint contained a combination of federal and state law claims. Based on the federal law claims, jurisdiction was invoked under 28 U.S.C. §1331. Jurisdiction over the state law claims was invoked under the doctrine of pendant jurisdiction or, alternatively, pursuant to 28 U.S.C. §1332 since diversity of citizenship existed between the plaintiffs and the defendants and the amount in controversy exceeded the jurisdictional amount.

affirmed the summary judgment in favor of Dean Witter with respect to nine federal and state law claims premised on the common law vicarious liability theories of respondeat superior and apparent authority, on the principal basis that no reasonably prudent person could suppose that Dean Witter had authorized transactions obviously designed to cheat it of commissions. App. at 19. The Seventh Circuit also affirmed the summary judgment entered in favor of Dean Witter on the only direct liability count, a negligence count, because Dean Witter owed no legal duty to Harrison as "no alleged fact indicates he was ever a customer of, had ever purchased a security from, or had ever placed an investment with . . . Dean Witter." App. at 21.

The Seventh Circuit, however, disagreed with the district court's conclusion that a broker-dealer's duties under Section 20(a) of the Securities Exchange Act of 1934, 15 U.S.C. §78t(a), do not extend to non-customers who choose to enter into transactions with a broker-dealer's employees that "any reasonable person, indeed any rational person, would have to conclude were personal transactions" (App. at 53-54) and, therefore, reversed the summary judgment entered in Dean Witter's favor on Harrison's Section 20(a) "control person" count. It is this last holding—a holding in conflict with the law of at least eight circuits—that Dean Witter petitions this Court to review.

REASONS FOR GRANTING THE WRIT

I. INTRODUCTION

The facts of this case are extreme and Dean Witter obviously believes that they should have resulted in a determination completely in its favor. It is difficult to accept that a broker-dealer may be sued, under any legal theory, by non-customer plaintiffs who conspired with two faithless employees to cheat the broker-dealer, simply because the employees cheated the plaintiffs instead. Nonetheless, the issue Dean Witter petitions this Court to review is not whether the Seventh Circuit misapplied settled law to the particular facts of this case. Rather, Dean Witter asks this Court to consider and decide whether the Seventh Circuit created new law, contrary to the settled law, by extending a broker-dealer's potential vicarious liability under Section 20(a) to personal transactions of employees for which the broker-dealer cannot be held liable at common law, even under the strict liability agency theories of respondeat superior or apparent authority.

As will be discussed below, the circuits' articulations of the law of Section 20(a) vary substantially. Although prior to the Seventh Circuit's decision in this case, there was no pressing need for this Court to intervene because the differences among the circuits were largely ones of language or form rather than of substance or application. The Seventh Circuit's decision to extend a broker-dealer's potential responsibility under Section 20(a) to employee conduct that falls outside the scope of any actual, implied, ostensible or apparent authority the employee might have had, however, is at odds with the language and legislative history of Section 20(a) and marks a sharp departure from the law of every other circuit—a departure that should be addressed by this Court.

II. NEITHER THE LANGUAGE NOR THE LEGISLATIVE HISTORY OF SECTION 20(a) SUPPORTS THE SEVENTH CIRCUIT'S HOLDING IN THIS CASE

Nothing in the language or legislative history of Section 20(a) indicates any intent on the part of Congress to expand an employer's or principal's liability for the acts of its employees or agents beyond the strict liability provided for by the common law doctrines of respondeat superior and apparent authority.[5] The purpose of Congress in enacting Section 20(a) was "to address the specific evil of persons seeking to evade liability under the [securities laws] by organizing 'dummies,' that, acting under their control, would commit the prohibited acts."[6] Thus, Section 20(a) potentially imposes vicarious liability on anyone who "directly or indirectly control[led]" the actual violator of the securities laws, including those (such as stockholders or directors) who would ordinarily be "beyond the reach of ordinary common law agency liability" because of the lack of the requisite employer-employee or principal-agent relationship.[7] The question that has generated considerable controversy and a substantial divergence of opinion among the circuits, however, is what role, if any, did Congress intend Section 20(a) to play in cases (such as this one) that

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[5] *See Hollinger v. Titan Capitol Corp.*, 914 F.2d 1564, 1579-83 (9th Cir. 1990) (Hall, J. dissenting), *cert. denied*, 111 S.Ct. 1621 (1991); *SEC v. Management Dynamics, Inc.*, 515 F.2d 801, 812 (2d Cir. 1975).

[6] *Paul F. Newton & Co. v. Texas Commerce Bank*, 630 F.2d 1111, 1118 (5th Cir. 1980); *see also Management Dynamics*, 515 F.2d at 812; Hearings on S. Res. 84 and S. Res. 56 and 97 Before the Senate Com. on Banking and Currency, 73d Cong., 1st Sess., pt. 15, at 6571 (1934).

[7] *In re Atlantic Financial Management, Inc.*, 784 F.2d 29, 33 (1st Cir. 1986), *cert. denied*, 481 U.S. 1072 (1987).

involve a traditional common law employer-employee or principal-agent relationship.

In enacting Section 20(a), Congress purposefully rejected a Senate proposal to impose an "insurer's liability" on control persons, in favor of a House version that expressly provides for a "good faith, non-inducement" defense to liability—a defense not available to employers or principals under the common law strict liability doctrines of respondeat superior and apparent authority.[8] As a result, until this case, virtually all courts recognized that Section 20(a), on its face, provides for narrower employer/principal liability than does the common law. Indeed, it is precisely this tension between the facially narrower vicarious liability provided for by Section 20(a) and the strict liability provided for under the common law that has led to such a great disparity in analysis (although, not in result) in cases involving traditional employer-employee relationships.

III. ALTHOUGH CONFUSED IN MANY OTHER RESPECTS, UNTIL THIS CASE, THE LAW OF THE VARIOUS CIRCUITS WAS CONSISTENT ON ONE POINT—A "CONTROL PERSON'S" LIABILITY DOES NOT EXTEND TO CONDUCT THAT THE PLAINTIFF KNEW OR SHOULD HAVE KNOWN WAS UNAUTHORIZED

The reluctance of the majority of circuits to allow broker-dealers to escape liability (by virtue of the "good faith" defense) for securities law violations of employees

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[8] *Rochez Brothers, Inc. v. Rhoades*, 527 F.2d 880, 885 (3d Cir. 1975), *cert. denied*, 425 U.S. 993 (1976); S. Rep. No. 47, 73d Cong., 1st Sess. 5 (1933) (The Fletcher Report); H.R. Rep. No. 85, 73d Cong., 1st Sess. 5 (1933); H.R. Conf. Rep. No. 152, 73d Cong., 1st Sess. 27 (1933).

or agents for which the broker-dealer would be liable under the common law has left the governing law under Section 20(a) in a state of apparent confusion. The differences in the various circuits' interpretations of Section 20(a) present a particularly muddled picture because of the substantial divergence of opinion on three distinct points—1) the applicable liability standard; 2) whether Section 20(a) preempts the common law in all securities law cases; and 3) whether the common law displaces Section 20(a) in cases involving traditional employer-employee or principal-agent relationships.

Prior to the Seventh Circuit panel's decision in this case, however, no court had ever interpreted Section 20(a) to provide that a broker-dealer is an insurer against fraud in the *personal* transactions of its employees with non-customers who had actual or constructive knowledge of the personal and unauthorized nature of those transactions. To the contrary, a principal premise of all previous decisions was that Section 20(a) provided for narrower employer liability than the strict liability provided for by the common law.

A. The Various Circuits' Articulations Of The Law Of Section 20(a) Differ In Several Significant Respects.

There is significant disagreement among the circuits concerning what the appropriate standard of liability should be in Section 20(a) cases. The Second, Third, Fourth, and Ninth (formerly) apply (applied) a "culpable participation"[9]

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[9] *See Lanza v. Drexel & Co.*, 479 F.2d 1277 (2d Cir. 1973) (en banc); *Rochez Brothers*, 527 F.2d at 885; *Carpenter v. Harris Upham & Co., Inc.*, 594 F.2d 388 (4th Cir.), *cert. denied*, 444 U.S. 868 (1979); *Christoffel v. E.F. Hutton & Co., Inc.*, 588 F.2d 665 (9th Cir. 1978).

standard that reflects an understanding that Congress intended liability under Section 20(a) to be premised on something more than mere control and, thus, that plaintiffs should be required to show "something more", i.e., participation in the underlying violation, as part of their prima facie case.[10] The First, Fifth, Eighth, Ninth (presently), and Tenth Circuits apply theoretically less restrictive standards[11] that treat lack of knowledge or involvement in the underlying violations as matters of defense.[12]

In deciding this case, the Seventh Circuit panel was chiefly concerned with resolving the choice between these two standards (formerly, an open question in the Seventh Circuit[13]) in favor of the less restrictive standard despite the fact that Dean Witter never, either in the district court or in the Court of Appeals, argued for the application of a culpable participation standard. To the contrary, Dean Witter has consistently maintained that the choice between a "culpable participation" or some lesser standard of liability is irrelevant to the resolution of this case because neither standard has ever been applied previously in a way that would allow for the imposition of liability on a broker-dealer for conduct of which it was unaware and that it neither actually nor apparently authorized.

The appropriate articulation of the standard of liability is not, however, the only point upon which the circuits

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[10] *See, e.g., Lanza*, 479 F.2d at 1299.

[11] *See Atlantic Financial Management*, 784 F.2d 29; *Paul F. Newton*, 630 F.2d at 1118-19; *Metge v. Baehler*, 762 F.2d 621 (8th Cir. 1985), *cert. denied*, 474 U.S. 1057 and 474 U.S. 1072 (1986); *Hollinger*, 914 F.2d at 1575; *First Interstate Bank of Denver, N.A. v. Pring*, 969 F.2d 891 (10th Cir. 1992).

[12] *See, e.g., First Interstate Bank*, 969 F.2d at 897-98.

[13] *See Schlifke v. Seafirst Corp.*, 866 F.2d 935, 949 (7th Cir. 1989).

disagree. Another significant (but less even) split exists with respect to whether Section 20(a) provides the sole basis for vicarious liability under the federal securities laws. The Third Circuit holds that it does because, in its opinion, allowing plaintiffs to rely alternatively on respondeat superior or apparent authority principles in employer-employee (principal-agent) cases would eviscerate Section 20(a)'s "good faith" defense.[14] The Ninth Circuit formerly agreed that Section 20(a) preempted common law vicarious liability in federal securities cases[15] but recently abandoned that approach (as well as the "culpable participation" standard).[16] All other circuits to have addressed this issue, however, hold that an employer (or principal) may be held liable for the securities law violations of its employees (or agents) by reference to common law agency or respondeat superior principles, despite Section 20(a)'s "good faith" defense. Although, even in this regard, the circuits have taken markedly different and inconsistent approaches.

For example, in abandoning its former position that Section 20(a) preempted respondeat superior, the Ninth Circuit has moved to the opposite extreme, holding that respondeat superior is the exclusive basis for imposing vicarious liability upon employers in securities law cases.[17] Thus, the Ninth Circuit now joins the First and Second (and the SEC) in the view that Section 20(a) is intended, exclusively, to bring "control persons" who are not employers or principals within the umbrella of potential vi-

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[14] *Rochez Brothers*, 527 F.2d at 885-86.

[15] *E.g.*, *Christoffel*, 588 F.2d at 667.

[16] *Hollinger*, 914 F.2d at 1575.

[17] *Hollinger*, 914 F.2d at 1577-78.

carious liability.[18] According to this view, Section 20(a) simply does not apply to employer-employee (principal-agent) relationships, because traditional common law principles of employer (principal) accountability govern in such cases.[19] The other circuits that permit common law principles to be applied in securities law cases, however, hold that these principles provide an alternative or supplementary basis for vicarious liability.[20]

B. Until This Case, All Circuits Agreed That A Control Person's Liability Under Section 20(a) Does Not Extend To Conduct That The Plaintiff Knew Or Should Have Known Was Unauthorized.

Despite their substantial disagreements about which liability standard to apply and whether Section 20(a) plays an exclusive, supplementary or no role in employer-employee cases, the circuits previously were in complete accord that Section 20(a) provided for control person liability that is no broader (except in terms of the types of "control" relationships that may support vicarious accountability) and that is, perhaps, substantially narrower (as a result of the express "good faith" defense) than the strict employer-principal liability provided for by common law. Indeed, as at least two circuits have observed, every significant Section 20(a) case (prior to this one) can be reconciled by reference to a single unifying theme—assuming a master-servant or principal-agent relationship, the same results

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[18] *See, Atlantic Financial Management*, 784 F.2d at 34; *Management Dynamics*, 515 F.2d at 812. *See also* Louis Loss, Fundamentals of Securities Regulation 1181 (1983).

[19] *Id.*

[20] *E.g., Atlantic Financial Management*, 784 F.2d at 33-34.

would have been reached through the straightforward application of common law respondeat superior or agency principles.[21] This analysis holds true with respect to all prior decisions of the Seventh Circuit,[22] as well as with respect to those decisions that differ as to whether traditional agency liability principles supplement, displace or are preempted by Section 20(a) in the employer-employee context.[23]

Even *Hollinger*, a case upon which the panel in this case relied quite heavily, holds that common law principles of respondeat superior or apparent authority define the *outer limits* of a "control person's" vicarious liability under the securities laws. As discussed above, in *Hollinger* the Ninth Circuit adopted the view of the First and Second Circuits that common law agency principles are the *exclusive basis* for imposing vicarious liability in securities law cases involving employer-employee relationships.[24] Moreover, *Hollinger* acknowledges that substantive com-

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[21] *See Atlantic Financial Management*, 784 F.2d at 31-35; *Marbury Management, Inc. v. Kohn*, 629 F.2d 705, 712-16 (2d Cir.), *cert. denied*, 449 U.S. 1011 (1980); *see, also*, Note, *Rule 10b-5—The Equivalent Scope of Liability Under Respondeat Superior and Section 20(a)—Imposing a Benefit Requirement on Apparent Authority*, 35 Vand. L. Rev. 1383 (1982).

[22] See, *e.g.*, *Sennott v. Rodman & Renshaw*, 474 F.2d 32, 39-40 (7th Cir.), *cert. denied*, 414 U.S. 926 (1973) (a broker-dealer cannot be held liable under 20(a) for transactions in which it was not involved and that it neither actually nor apparently authorized).

[23] *Compare Fey v. Walston & Co. Inc.*, 493 F.2d 1036, 1052 (7th Cir. 1974) (supplement); *Holloway v. Howerdd*, 536 F.2d 690, 694-95 (6th Cir. 1976) (same); with *Marbury Management*, 629 F.2d at 716 (displace); *Hollinger*, 914 F.2d at 1578-79 (same); and with *Christoffel*, 588 F.2d at 668 (preempted by); *Rochez Brothers*, 527 F.2d at 885 (same).

[24] 914 F.2d at 1578-79.

mon law agency principles govern even when Section 20(a) is applicable (non-master, non-principal cases),[25] by stating that there can be no Section 20(a) liability when it is established that the plaintiff did not *reasonably rely* upon a belief that the "controlled" person was acting on behalf of the "controlling" person.[26]

IV. THE CONFLICT BETWEEN THE SEVENTH CIRCUIT'S INTERPRETATION OF SECTION 20(a) AND ALL PRIOR INTERPRETATIONS IS DRAMATIC AND OF CONSIDERABLE PRACTICAL CONSEQUENCE

The contrast between the law made by the Seventh Circuit panel in this case and the law of all other circuits is dramatic and of considerable practical consequence. Under the panel's holding in this case, any third person dealing with an employee of a broker-dealer—regardless of whether the employee is acting in a personal capacity; regardless of whether any reasonable third person would appreciate that the employee was acting in a personal capacity; regardless of the third person's total lack of customer relationship (past or present) with the broker-dealer; and regardless of whether the transaction was successfully concealed from the broker-dealer—may hold the broker-dealer accountable for any of the employee's wrongdoing *unless the broker-dealer proves* that it had a proper

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[25] The primary issue decided in *Hollinger* was whether broker-dealers can shield themselves from Section 20(a) liability by engaging registered representatives as independent contractors rather than as employees. 914 F.2d at 1574. As Section 20(a) was specifically designed to allow piercing of corporate or other technical legal shields to liability, the Ninth Circuit correctly held that broker-dealers cannot. *Id.*

[26] *Id.* at 1575 n.26.

supervisory system in place that it diligently enforced. But what kind of supervisory system is proper with respect to an employee's personal transactions with non-customers?

One would think that a system sufficient to insure that any reasonable non-customer will appreciate that the broker-dealer has not authorized and is not involved in the employee transactions would be adequate. Yet, apparently it is not (at least in the Seventh Circuit) because Dean Witter undisputedly had and enforced such a system—the monitoring of all correspondence sent from or received at the office and the interception of all incoming checks. App. at 30, 38. Must a broker-dealer, then, tap and continuously monitor all telephone conversations of its employees, verify the source of all funds deposited in an employee's account, and question all of an employee's potential lenders just to insure that unreasonably gullible (or dishonest) non-customers are not somehow being defrauded?

In effect, the Seventh Circuit has created an incredibly broad, implied cause of action against broker-dealers for negligent supervision in which the only essential element of a plaintiff's prima facie case is that an employee of the broker-dealer violated the securities laws. Under the holding in this case, if the plaintiff can show only this much, the burden of proof shifts to the defendant broker-dealer to establish that it was not negligent in any aspect of its supervision. Such a cause of action is much broader than any action founded on common law theories of negligence, respondeat superior or apparent authority. Indeed, even in product liability cases a plaintiff must at least show that the defendant actually manufactured or was involved in the distribution of the product causing the injury. Here, however, Dean Witter was found to be potentially liable under Section 20(a) even after it met the substantial burden of establishing that, on the *undisputed*

facts, no reasonable person could have believed that Dean Witter had authorized or was involved in the violative conduct of its employees, as a matter of law.

If, contrary to the express or implicit holdings of virtually all other circuits, the legislative history, and the plain statutory language, Congress intended Section 20(a) to place such costs on broker-dealers—costs that have not been imposed on broker-dealers for the first sixty years of the statutes' life—it should be the job of Congress or, at least, this Court to say so. A coherent, cohesive, and consistent federal scheme for the fair regulation of the securities industry cannot otherwise be realized.

CONCLUSION

For the above stated reasons, Petitioner Dean Witter Reynolds Inc. respectfully urges this Court to grant its petition for writ of certiorari to the United States Court of Appeals for the Seventh Circuit.

Respectfully submitted,

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APPENDICES

APPENDIX A

IN THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

Nos. 91-1458 & 91-1592

HUDSON T. HARRISON and HARRISON CONSTRUCTION INCORPORATED, a corporation,

Plaintiffs-Appellants, Cross-Appellees,

v.

DEAN WITTER REYNOLDS, INCORPORATED, a corporation,

Defendant-Appellee, Cross-Appellant.

Appeals from the United States District Court
for the Northern District of Illinois, Eastern Division.
No. 86 C 8003—**Brian Barnett Duff**, *Judge*,
and **George W. Lindberg**, *Judge*.

ARGUED FEBRUARY 10, 1992—DECIDED SEPTEMBER 8, 1992

Before KANNE, *Circuit Judge*, WOOD, JR., *Senior Circuit Judge*, and SHARP, *District Judge*.*

WOOD, JR., *Senior Circuit Judge*. For nearly eighteen months Hudson T. Harrison, an Illinois resident, sent his

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* The Honorable Allen Sharp, Chief Judge, United States District Court for the Northern District of Indiana, sitting by designation.

and his company's money to a Dean Witter Reynolds, Inc. ("Dean Witter") account executive and vice president, John G. Kenning, in Boca Raton, Florida, for investment in low-risk municipal bonds. Both Kenning and his assistant, John M. Carpenter, offered Harrison an opportunity he could not resist: If he sent money to them personally, they would place it in Carpenter's personal, employee account at Dean Witter and then invest it in a specially available, municipal-bond fund. This misuse of the employee account would yield Harrison a significantly increased return because the bonds would be purchased at Dean Witter's cost and at the reduced commission allowed on employees' own transactions. Dean Witter's rules prohibited using employee accounts in this manner.

All tolled, Mr. Harrison and his company, Harrison Construction Inc. (collectively "Harrison"), the plaintiffs-appellants here, invested roughly $4 million. A few payments, or investments, were made by wire transfer to Carpenter's personal checking account, but most were made by check, mailed to Carpenter's home. In return Harrison received personal, promissory notes signed initially by Carpenter and later by both Kenning and Carpenter. These notes offered annualized interest rates of approximately 18% to 60%. Dean Witter points out, however, that Harrison received two notes for each transaction: one accurately stated his anticipated return, and the other, which he used for income-tax purposes, materially understated it.

The scheme, however, was a fraud perpetrated by Kenning and Carpenter, who invested not in municipal bonds but in much riskier put options. These investments went sour. Harrison and roughly 125 other investors lost most of their money. Kenning and Carpenter were later sentenced to eight and four years' incarceration, respectively, in a federal penitentiary for their criminal acts and ordered to pay $8 million restitution.

Harrison sued not only Kenning and Carpenter but also Dean Witter, seeking to impose both vicarious and direct liability. He raised claims under Section 10(b) of the Securities Exchange Act of 1934 (the "1934 Act"), 15 U.S.C.

§ 78j(b); Section 20(a) of the 1934 Act, 15 U.S.C. § 70t(a); the Racketeer Influenced and Corrupt Organizations Act ("RICO"), 18 U.S.C. §§ 1961 *et seq.*; state common law; and one state statute. One of the RICO claims was dismissed early on. *Harrison v. Dean Witter Reynolds, Inc.*, 695 F. Supp. 959 (N.D. Ill. 1988). The other claims succumbed to Dean Witter's motion for summary judgment. *Harrison v. Dean Witter Reynolds, Inc.*, 715 F. Supp. 1425 (N.D. Ill. 1989). The case was then transferred from Judge Duff to Judge Lindberg, who imposed sanctions under Fed. R. Civ. P. 11 on Harrison's attorney, Thomas P. Ward, for raising two frivolous claims. *Harrison v. Dean Witter Reynolds, Inc.*, 132 F.R.D. 184 (N.D. Ill. 1990). These Rule 11 sanctions resulted in an award of attorney's fees in the amount of $20,860.50. *Harrison v. Dean Witter Reynolds, Inc.*, No. 86 C 8003, Memorandum Opinion and Order (N.D. Ill. Oct. 19, 1990). Kenning and Carpenter were then dismissed on Harrison's motion under Fed. R. Civ. P. 41(a), and final judgment was entered February 6, 1991. Harrison appeals the grant of summary judgment in favor of Dean Witter and the imposition of sanctions; Dean Witter appeals the partial denial of sanctions. For the reasons stated below we affirm in part and reverse in part.

ANALYSIS

Diversity jurisdiction exists over the state-law claims. Plaintiff, Hudson T. Harrison, is a citizen of Illinois. Plaintiff, Harrison Construction, Inc., is an Illinois corporation with its principal place of business in Illinois. The defendant, Dean Witter is a Delaware corporation with its principal place of business in New York. The former defendants, Kenning and Carpenter, were citizens of Florida. The amount in controversy exceeds $50,000. 28 U.S.C. §1332. We reserve for the moment Dean Witter's contention that we do not have jurisdiction over the appeal with respect to the Rule 11 sanctions imposed.

We review *de novo* a district court's decision to grant summary judgment, viewing the facts in a light most favorable to the nonmoving party. *Prince v. Zazove*, 959

F.2d 1395, 1398 (7th Cir. 1992); *Ooley v. Schwitzer Division, Household Manufacturing Inc.*, 961 F.2d 1293, 1297 (7th Cir. 1992). "The movant has the burden of showing that there is no genuine issue of fact, but . . . [under Fed. R. Civ. P. 56(e) the nonmoving party] must set forth specific facts showing that there is a genuine issue for trial." *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 256 (1986). Where a party who bears the burden of proof fails to establish an essential element in its case, "there can be 'no genuine issue as to any material fact' . . . [and] all other facts [become] immaterial." *Celotex Corp. v. Catrett*, 477 U.S. 317, 322-33 (1986) (quoting Fed. R. Civ. P. 56(c)). *See also Matsushita Electric Industrial Co. v. Zenith Radio Corp.*, 475 U.S. 574, 585-87 (1986).

SECTION 20(a)[1]

The district court based its grant of summary judgment on the proposition of law that under Section 20(a) of the 1934 Act the plaintiff must show "the defendant exercised some control over the wrongdoer with respect to the wrongful acts." *Harrison v. Dean Witter Reynolds, Inc.*, 715 F. Supp. 1425, 1436 (N.D. Ill. 1989) (citing *Christoffel v. E.F. Hutton & Co.*, 588 F.2d 665, 668 (9th Cir. 1978)). This is known as the "culpable participant" requirement or test. *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1574-75 (9th Cir. 1990) (en banc), *cert. denied*, 111 S. Ct. 1621 (1991); *Schlifke v. Seafirst Corp.*, 866 F.2d 935, 949 (7th Cir. 1989). The court then found, as a matter of law:

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[1] Section 20(a) of the 1934 Act establishes liability as follows:

> Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

15 U.S.C. § 78t.

> Dean Witter exercised no control over Kenning and Carpenter with respect to their sales of promissory notes[(the allegedly fraudulent acts)]. It did not know of these sales, nor could it have known of them, since Carpenter and Kenning structured their arrangement with Harrison to ensure that Harrison would not send any money to them at the office. Further, the sales were conducted in the names of Kenning and Carpenter alone; the payments on the notes were by Carpenter's personal checks; and Harrison never contacted Dean Witter to inquire about his investments.

Harrison, 715 F. Supp. at 1437.

In applying the culpable-participant test from *Christoffel*, the district court used a test we have never approved, a test, the rigors of which contravene our prior holdings, and a test expressly overruled, en banc, by the Court of Appeals for the Ninth Circuit in *Hollinger*, 914 F.2d at 1575.

In *Schlifke* we stated,

> This circuit has not crystallized the test for determining when liability may be imposed on a "controlling person," yet in *Barker* we stated that "the ability to persuade and give counsel is not the same thing as 'control', which almost always means the practical ability to *direct* the actions of the people who issue or sell the securities."

Schlifke, 866 F.2d at 949 (citing *Barker v. Henderson, Franklin, Starnes & Holt*, 797 F.2d 490, 494 (7th Cir. 1986); emphasis in *Barker*). We then stated, "We need not decide whether to adopt this more rigorous[, 'culpable-participation'] formulation for the [defendant] Bank was not a 'controlling person' even under the less demanding *Metge* test." *Schlifke*, 866 F.2d at 949. In *Metge v. Baehler*, 762 F.2d 621 (8th Cir. 1985), *cert. denied*, 474 U.S. 1057; 474 U.S. 1072 (1986), the court had held:

> [P]laintiffs must establish, first, that the defendant lender actually participated in (*i.e.*, *exercised* control

> over) the operations of the corporation *in general*; then he must prove that the defendant possessed the power to control the specific transaction or activity upon which the primary violation is predicated, but he *need not prove that this later power was exercised.* [Quotation marks and citation omitted.] We approve this test because it complies with precedents which counsel broad remedial construction of the statute and because it complies with precedents that distinguish between actual exercise of control in the violator's principal affairs and potential control over the violation.

Metge, 762 F.2d at 631 (first emphasis in original, others added).

While the *Schlifke* court clearly did not adopt the culpable-participation test, neither did it expressly adopt the two-pronged *Metge* test. The court did state, however, it agreed "fully with the district court's analysis," which utilized the *Metge* test. *Id.* at 949. Significantly, the control-person test approved in *Metge* was that used by the district court in *Metge v. Baehler*, 577 F. Supp. 810, 817-18 (S.D. Iowa 1984), which in turn applied elements stated in *Stern v. American Bankshares Corp.*, 429 F. Supp. 818 (E.D. Wis. 1977).

> There is no requirement that the controlling person exercise control over the particular transaction which gives rise to the violation. . . .
>
> . . . .
>
> What the plaintiff in this action must establish is that those persons whom he contends are controlling persons have actively participated in the operations of [defendant] Bankshares and possessed actual control over the transaction in question. Once that is established the matters of knowledge and actual participation, which directly or indirectly induced the fraud, are matters for the defense.

Stern, 429 F. Supp. at 823-24 (citations omitted). Moreover, the *Metge* test comports with the definition of "control" promulgated by the Securities and Exchange Com-

mission ("SEC")[2] and, as we shall now see, with our prior holdings, which also counsel broad remedial construction of the statute and recognition of a practical ability to direct the actions of those involved.

In *SEC v. First Securities Co. of Chicago*, 463 F.2d 981 (7th Cir.), *cert. denied*, 409 U.S. 880 (1972) ("*First Securities I*"), and a companion case, *SEC v. First Securities Co. of Chicago*, 466 F.2d 1035 (7th Cir.), *cert. denied*, 409 U.S. 1041 (1972) ("*First Securities II*"), we reversed the district court, which had disallowed a number of liability claims brought under Section 20(a). Leston B. Nay, president of First Securities and owner of 92% of its stock, had defrauded at least sixteen clients by inducing them to invest in spurious, high-interest, escrow accounts that, upon his suicide, June 4, 1968, were worthless. Typically, an investor would sell already owned securities through First Security; First Security would collect a commission on the sale and forward the remainder to the investor, who then would draw a personal check payable to Nay or to a bank for his account. Nay issued receipts that took the form of a purported agreement or promissory note from him. Erratically, Nay made what appeared to be interest payments to the investors by personal check in envelopes on which First Securities's name and address appeared. In *First Securities I*, 463 F.2d at 985, the court observed,

> Finally, it is clear that Nay had no actual authority to act for First Securities with regard to the escrow account. It is also clear that First Securities' employees (other than Nay) knew nothing of the nature of the escrow nor, except for his secretary, even of its

[2] "The term 'control' (including the terms 'controlling,' 'controlled by' and 'under common control with') means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise." 17 C.F.R. § 240.12b-2.

> existence. Nay had forbidden anyone other than himself to open mail addressed to him . . . .

The court concluded that it "had no doubt Nay, being the employee of First Securities as its president, was 'controlled' by First Securities within the intendment of section 20(a)." *Id.* at 987 (citation omitted). Moreover,

> First Securities made Nay its president, provided him with the trappings of a successful investment counsellor, held him out as providing such counsel, and then wilfully allowed Nay's enforcement of a rule regarding the opening of mail which was antithetical to the prevention of frauds of the type which occurred.

Id. at 988. After quoting this statement, the *First Securities II* court added, "First Securities also provided Nay with the printed letterheads, printed safekeeping receipts, rubber stamps and other supplies and accoutrements which enabled him to perpetrate and perpetuate his frauds." *First Securities II*, 466 F.2d at 1040.

In *Sennott v. Rodman & Renshaw*, 474 F.2d 32 (7th Cir.), *cert. denied*, 414 U.S. 926 (1973), we reversed a district court's finding of brokerage-house liability where no one at the brokerage itself had participated in the fraudulent acts. The actual fraud was committed by Jordan Rothbart some six years after he left the brokerage firm of Rodman & Renshaw. He became a commodities trader and member of the Chicago Board of Trade, where he met the plaintiff, Sennott, to whom he purported to sell $142,000 in stock options which, it turned out, never existed. The court found, however, that Rothbart's other transactions with Sennott, had they been fraudulent, would have imposed liability on Rodman & Renshaw under Section 20(a). As described by the court,

> A typical [non-fraudulent] transaction involved Jordan [Rothbart] advising Sennott that his father[, William, a registered representative of Rodman & Renshaw,] believed a particular stock should be bought or sold, Sennott indicating a desire to purchase, and Jordan going to the Rodman phone on the Board of Trade

> floor and calling in the order. Shortly thereafter Sennott would receive a mailed confirmation slip from Rodman. Sennott, of course, paid brokerage fees on all of these transactions.

Sennott, 474 F.2d at 34 (footnote omitted). The court concluded that while Rodman & Renshaw could be held liable under Section 20(a) for the just-described transactions, there was

> not an adequate foundation upon which to base liability where Rodman was admittedly not considered to be involved in the transaction. Rodman's duty to control its partners and agents, as well as its past employees, in situations such as this extends only to transactions with or by these parties where Rodman is itself involved.

Id. at 39-40.

In *Henricksen v. Henricksen*, 640 F.2d 880 (7th Cir.), *cert. denied*, 454 U.S. 1097 (1981), we reversed a district court's finding that a brokerage firm, Smith Barney, was liable under Section 20(a) for the fraudulently garnered commissions and margin expenses but not for the conversions by its salesman-agent, George Henricksen. We held Smith Barney was liable for the conversions, too.

> Having entrusted her investment to Smith Barney's management through George [Henricksen], their agent, Wendee [Henricksen, George's former wife,] was entitled to rely on Smith Barney's fiduciary obligation to manage the investments in accordance with her recorded investment objectives and George's best professional judgment subject to the review and ultimate control of Smith Barney's supervisory personnel.

Henricksen, 640 F.2d at 888.

Lastly, we have affirmed a finding by the Commodity Futures Trading Commission that a commodity brokerage firm, Rosenthal & Company, was liable under Section 2(a) of the Commodity Exchange Act for the fraudulent acts of a non-employee who was, nevertheless, a manager, as-

sociate, and registered representative of the firm. 7 U.S.C. § 4; *Rosenthal & Company v. Commodity Futures Trading Commission*, 802 F.2d 963 (7th Cir. 1986). Of particular relevance for us is the observation in *Rosenthal* that, although we affirmed the Commission's finding of liability, we could have, with equal justification, affirmed a finding that Rosenthal was not liable.

> [W]e don't suppose that we or any other court would think the Commission had taken leave of its senses [had it accepted Rosenthal's line of argument]. But we also think the Commission was entitled, without being deemed to have acted unreasonably or without substantial evidence, to conclude that [co-defendant] Pinckney was acting within the scope of his agency [with Rosenthal].

Id. at 968. The issue was factual, and it was the fact-finder's choice to find liability or not.

Those cases in which we have found control wanting help define the boundaries of "control person." In *Barker v. Henderson, Franklin, Starnes & Holt*, 797 F.2d 490 (7th Cir. 1986), we affirmed that neither the law firm which had provided legal advice nor the accounting firm which had furnished accounting services with regard to certain bonds were control persons. Neither firm had the ability to control the bond issuer; both firms had only the "ability to persuade and give counsel[, which] . . . is not the same thing as 'control.' " *Id.* at 494. Neither firm had the authority to direct the actions of the bond issuer; additionally, neither had received the selling materials until after they were issued. *Id.* In *Sennott* there was no liability because there was no person which the brokerage firm could control; the fraud involved no member or representative of the firm. Rather, it was the non-fraudulent transactions which could have brought liability to the firm; one of its members did participate in the transactions, and the firm, inter alia, received attendant commissions.

In *Schlifke*, we affirmed a grant of summary judgment for the defendant, the parent corporation of a bank that

had made a loan, secured by letters of credit, to an oil-and-gas limited partnership. The loan documents appeared in the prospectus. We found that the bank "had no power to control the . . . sales personnel or to dictate the manner in which the allegedly fraudulent sales of securities were made; it merely prescribed requirements for the letters of credit . . . ." *Schlifke*, 866 F.2d at 950. In a diversity action arising under the Illinois Securities Law of 1953, ILL. REV. STAT. ch. 121½, §§ 137.1 *et seq.*, we affirmed a district court's finding that the broker and its salesperson were jointly and severally liable and that the clearing agent, Bear, Stearns, was not:

> [A]s the clearing agent in these transactions, Bear, Stearns did not play a central or specialized role. Instead, it performed a simple, albeit necessary, accounting function in order to process the orders. We will not impose the broad liability reserved under the Illinois Act for underwriters, dealers or salespersons for the performance of such limited, ministerial acts.

Carlson v. Bear, Stearns & Co., 906 F.2d 315, 317 (7th Cir. 1990). The point is well made.

Clearly, we have never approved or used the culpable-participant test, nor have we ever used any similar test to so stingily limit the definition of control person. Moreover, the court of appeals that Judge Duff unfortunately relied upon as precedent for the culpable-participant test has, since, expressly rejected that test and has, instead, adopted a test which greatly expands Section 20(a)'s circle of liability.

The Court of Appeals for the Ninth Circuit, sitting en banc, reversed a district court's summary judgment for the defendant and held "that a broker-dealer is a controlling person under § 20(a) with respect to its registered representatives." *Hollinger*, 914 F.2d at 1573. In so doing, the court overruled prior decisions in *Christoffel*, the case relied upon by Judge Duff, and *Buhler v. Audio Leasing Corp.*, 807 F.2d 833 (9th Cir. 1987), among others. The court expressly rejected the "culpable participation" test

of control (*Hollinger*, 914 F.2d at 1575), stating, instead, that a plaintiff "need only show that . . . [the actor] was not himself a registered broker-dealer but was a representative employed by or associated with a registered broker-dealer." *Id.* at 1574. But as the court explained:

> [W]e do not mean that a broker-dealer is vicariously liable under § 20(a) for all actions taken by its registered representatives. Nor are we making the broker-dealer the "insurer" of its representatives . . . . [T]he "controlling person" can avoid liability if she acted in good faith and did not directly or indirectly induce the violations.

Id. at 1575. In a footnote the court observed,

> The broker dealer may also, of course, rely on a contention that the representative was acting outside the broker-dealer's statutory "control." For example . . . [the plaintiff was] placing the money with . . . [the actor] for purposes other than investment in markets to which [the actor] had access only by reason of his relationship with [the] broker-dealer . . . .

Id. at 1575-76 n.26.

We have long viewed the statute as remedial, to be construed liberally, and " 'requiring only some indirect means of discipline or influence short of actual direction to hold a "control person" liable.' " *First Securities I*, 463 F.2d at 987 (quoting *Myzel v. Fields*, 386 F.2d 718, 738 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968), which was cited for the same proposition by *Metge*, 762 F.2d at 630). We have never construed "control" as narrowly as the district court below, nor have we construed it as broadly as the court in *Hollinger*. We have looked to whether the alleged control-person actually participated in, that is, exercised control over, the operations of the person in general and, then, to whether the alleged control-person possessed the power or ability to control the specific transaction or activity upon which the primary violation was predicated, whether or not that power was exercised.

Here Harrison alleged and Dean Witter has not disputed that Dean Witter is a broker-dealer and that Kenning and Carpenter were its employees—the former as a registered representative, vice president, and account executive and the latter as a registered representative and Kenning's assistant. Additionally, both had assigned office-space at the Boca Raton branch of Dean Witter, a local, office telephone number, an "800" telephone number, and "Dean Witter" business cards, among other indicia of authority. Carpenter but not Kenning, who was facing bankruptcy, maintained an employee account at Dean Witter; Kenning actually controlled it, however. Dean Witter's rules required the local branch manager to sign all order tickets for employee accounts and to monitor the accounts' activities; the rules also prohibited commingling employee and client funds as well as sharing an interest in an account with anyone other than a close relative. Nonetheless, Harrison's money, sent to Kenning and Carpenter either at home or to a personal bank account, always landed rather quickly in Carpenter's account at Dean Witter.

The alleged facts are sufficient to prevent our finding, as a matter of law, either that Dean Witter did not actually exercise control over the operations of Kenning and Carpenter in general or that Dean Witter did not possess the power or ability to control Kenning and Carpenter's transactions upon which the primary violation is predicated. Accordingly, it was error to grant Dean Witter's motion for summary judgment on the basis that Dean Witter was not a controlling person. We leave that determination to the factfinder.

But the analysis does not end here. The statute provides an affirmative defense for controlling persons, one which the defendant bears the burden of proving. *Fey v. Walston & Co.*, 493 F.2d 1036, 1051-52 (7th Cir. 1974); *Hollinger*, 914 F.2d at 1575 n.25 (citing, inter alia, *Fey*, 493 F.2d at 1051-52). Section 20(a) of the 1934 Act provides that a controlling-person defendant is not liable if the defendant can show he or she "acted in good faith and did not directly or indirectly induce the act or acts

constituting the violation or cause of action." 15 U.S.C. § 78t. Thus, once controlling-person status is shown, "a broker-dealer would be liable for its employee's acts under Section 20(a) if it 'did not maintain a reasonably adequate system of internal supervision and control over the [registered representative] or did not enforce with any reasonable diligence such system * * * .'" *Henricksen v. Henricksen*, 640 F.2d 880, 884 (7th Cir.), *cert. denied*, 454 U.S. 1097 (1981) (quoting *Fey*, 493 F.2d at 1051; bracketed material and asterisks added by the *Henricksen* court). In affirming the district court's finding of liability, the *Henricksen* court held, inter alia,

> We cannot agree, however, that Smith Barney was reasonably diligent in its supervision of the trading in . . . [the plaintiff's] account, and we further conclude that this lack of reasonable diligence in combination with the generally casual supervision of . . . [the defendant employee's] activities contributed not only to the trading losses and commission expenses but to the conversions as well.

Id. at 885.

The alleged facts indicate Dean Witter had rules in place to prevent various types of fraud. For example, in addition to those noted above, the rules also required that supervisors ensure an employee's investments were commensurate with his or her resources. Indeed, on more than one occasion the head of Dean Witter's compliance department asked the local branch manager to investigate the heavy volume in Carpenter's account. He did ask Carpenter and Kenning about it, but apparently accepted without further investigation Carpenter's explanation that it was his own money. *Harrison*, 715 F. Supp. at 1425. As it turned out, the two lost some $600,000 in roughly their first year at Dean Witter and some $2,000,000 over the ensuing two years without attracting, what they might consider, unwarranted attention. Under the alleged facts of the present case we cannot say, as a matter of law, that Dean Witter acted in good faith and neither directly nor indirectly induced the act or acts constituting the

violation. This determination, too, must be left to the factfinder.

CHOICE OF LAW

The district court applied Illinois law to all state-law claims Harrison raised. He argues this was error and that Florida law controls these claims. Dean Witter responds that Harrison failed to object to the district court's applying Illinois law and, thus, cannot raise this issue on appeal.

Under *Erie* and *Klaxon* a federal court exercising diversity jurisdiction "must look to the law of the forum in which it sits for substantive law, . . . including the rules governing choice of law." *International Administrators, Inc. v. Life Insurance Co. of North America*, 753 F.2d 1373, 1376 n.4 (7th Cir. 1985) (citing *Erie Railroad Co. v. Tompkins*, 304 U.S. 64, 71-80 (1938), and *Klaxon Co. v. Stentor Electric Manufacturing Co., Inc.*, 313 U.S. 487, 496 (1941)). However, where, on the record, neither party objected to the district court's choice of law, "it is not open to us to reconsider that issue, absent some compelling reason of policy." *International Administrators*, 753 F.2d at 1376 (footnote omitted). Moreover, if neither party argues for application of a particular state's law, the law of the forum is presumptively applied. *Wood v. Mid-Valley Inc.*, 942 F.2d 425, 426 (7th Cir. 1991). Harrison cites no objection made on the record and does not claim to have otherwise raised the issue before the judge,[3] and the district court did apply the law of the forum state, Illinois. Accordingly, Harrison has waived the issue on appeal, and, under the circumstances, the court did not err in applying Illinois law to all of the state-law claims, whether they sought to impose direct or vicarious liability.

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[3] At oral argument Harrison's attorney, who was also the attorney below, acknowledged that, before Judge Duff, which state's law applied was "[n]ever contested. . . . No argument by them; no argument by us on it."

Harrison, nonetheless, argues he adequately raised the choice-of-law question in his first amended complaint in Counts X and XII. Harrison claims his reference in Count X (denominated, simply, "Conversion"), paragraph 85(a), to his prayer for "three-fold" damages identifies a sufficient argument for applying Florida law because Illinois has no comparable damages provision.[4] This argument is not sufficient to survive the rule of waiver. Neither has he presented a "compelling reason of policy" for applying Florida law by arguing that Florida allows a treble-damage award for conversion and Illinois does not. Furthermore, in relying solely on a damages argument he ignores the necessary predicate, a finding of liability, and, consequently, has not made the requisite argument that there is a "compelling reason of policy" to apply the Florida law of liability rather than the Illinois law. In Count XII Harrison did cite FLA. STAT. ch. 517.211 and 517.301, but, as in most of the other counts, he does not seek to impose direct liability on Dean Witter. Rather, he seeks to impose vicarious liability for the acts of Kenning and Carpenter via *respondeat superior*. Thus, Harrison must show he also preserved the choice-of-law question with respect to the law of agency. This he has not done.

RESPONDEAT SUPERIOR

Finding the undisputed facts did not support Harrison's claim that Kenning and Carpenter had either actual or apparent authority from Dean Witter for their fraudulent acts, the district court granted Dean Witter summary judgment on the issue of *respondeat superior*. Harrison appeals only with respect to the issue of apparent author-

[4] Harrison also argues that in Count X, paragraphs 62-67, of his original complaint he expressly identified the Florida Civil Theft Act, FLA. STAT. ch. 812.014(1). If anything, this argument is detrimental, because the express citation is nowhere to be found in Count X or any other count of the first amended complaint or, apparently, anywhere else in the record on appeal. At least, Harrison does not claim to have expressly cited that statute elsewhere.

ity but adds arguments that Kenning and Carpenter were acting within the scope of their employment and that their being employees or servants of Dean Witter subjects Dean Witter to "status-based" liability.

Because we agree with the district court that, as a matter of law, neither Kenning nor Carpenter bore the mantle of apparent authority, Harrison's two additional arguments fail. The first argument fails because Kenning and Carpenter had no authority to commit the fraud and neither one was seeking to benefit the employer.[5] Thus, they were acting outside the scope of their employment. The second argument fails because it requires a showing that the agent was "apparently acting within his authority," and, as we shall now see, neither Kenning nor Carpenter were. Restatement (Second) of Agency § 261.

A recent decision of the Illinois Supreme Court, unfortunately not available to the parties before briefing, well summarizes the law of agency with respect to apparent authority.

> It is a well-established precept of agency law that a principal will be bound by the authority he *appears* to give to another, as well as the authority which he actually gives. Apparent authority arises where a principal creates, through words or conduct, the reasonable impression that the putative agent has been granted authority to perform certain acts. Apparent authority is that authority which a reasonably prudent person, in view of the principal's conduct, would naturally suppose the agent to possess.

State Security Insurance Co. v. Burgos, 145 Ill.2d 423, 164 Ill. Dec. 631, 583 N.E.2d 547, 551 (1991) (summary judgment finding apparent authority affirmed; citations omitted including two cited by Harrison; emphasis in *Burgos*).

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[5] While it may be argued that Dean Witter received commissions on the activity Carpenter's account generated, it must be noted the commissions would have been greater had the activity been in a regular customer's account.

As stated earlier by the Illinois Supreme Court, "The theory of apparent authority rests on two premises: a manifestation by the principal to a third party, and belief by that third party that the extent of the authority granted to the agent encompasses the contemplated activity." *Simpson v. Compagnie Nationale Air France*, 42 Ill.2d 496, 248 N.E.2d 117, 120 (1969) (citing Restatement (Second) Agency § 8).[6] Also citing Restatement (Second) Agency, but at Section 261, Comment *a*, the Supreme Court similarly observed:

> Under an apparent authority theory, '[l]iability is based upon the fact that the agent's position facilitates the consummation of the fraud, in that from the point of view of the third person the transaction seems regular on its face and the agent appears to be acting in the ordinary course of the business confided to him.'

American Society of Mechanical Engineers, Inc. v. Hydrolevel Corp., 456 U.S. 556, 566 (1982). Clearly, an essential element is the third party's reasonable belief that the agent is acting within the authority granted by the principal, that the transaction appears to be regular and in the ordinary course of business. That element is missing from Harrison's case.

Here the undisputed facts show Harrison did not open an account with Dean Witter but, instead, transferred money to Kenning and Carpenter for them to place in Carpenter's employee account at Dean Witter for subsequent investment. In so doing, Harrison expected to enhance his return by paying the lower commission charged Dean Witter employees, although he was not an employee

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[6] In the first decade of this century the Illinois court had held: "It rested upon the plaintiff to affirmatively show that [the act] . . . was within the apparent scope of the authority of the [employee] . . . and that he did not know or have reasonable grounds to believe that the [employee] was exceeding his authority." *Illinois Central Railroad Co. v. Jennings*, 217 Ill. 140, 75 N.E. 457, 459 (1905).

entitled to that benefit. It is clear neither Kenning nor Carpenter had the authority, either actual or apparent, to use the account thusly; Dean Witter's rules expressly forbad it, as would ordinary prudence.

We cannot nor can any reasonably prudent person naturally suppose that Kenning and Carpenter possessed the authority to use the employee account for Harrison's benefit. It simply is not believable that their authority would extend so far. Furthermore, Harrison's transactions with Kenning and Carpenter were not regular on their face and could not appear to be within the ordinary course of business, within the ordinary course of their business, at Dean Witter.

Therefore, we hold the district court correctly found Dean Witter was not liable under *respondeat superior* for any of the state-law, vicarious liability claims Harrison raised.

NEGLIGENT HIRING AND RETENTION

Illinois, in *Tatham v. Wabash Railroad Co.*, 412 Ill. 568, 107 N.E.2d 735 (1952), recognized an employee's intentional tort as a basis for the tort of negligent hiring and retention. *Becken v. Manpower, Inc.*, 532 F.2d 56, 58 (7th Cir. 1976); *Bates v. Doria*, 150 Ill. App. 3d 1025, 104 Ill. Dec. 191, 502 N.E.2d 454, 458 (2nd Dist. 1986). Accordingly, "an employer is liable for hiring and retaining unfit and incompetent employees . . . where there has been an intentional tort or criminal conduct by the employee." *Martin v. Yellow Cab Co.*, 208 Ill. App. 3d 572, 153 Ill. Dec. 503, 567 N.E.2d 461, 466 (1st Dist. 1990) (citation omitted); *Tatham*, 107 N.E.2d at 739. This is a negligence tort; thus, "the plaintiff's allegations must establish (1) the existence of a duty of care owed by the defendant to the plaintiff, (2) a breach of that duty, and (3) injury to plaintiff (4) proximately resulting from the breach." *Puckett v. Mr. Lucky's Ltd.*, 175 Ill. App. 3d 355, 125 Ill. Dec. 93, 529 N.E.2d 1169, 1172 (4th Dist. 1988) (Knecht, J., dissenting; citations omitted); *see also McLane v. Russell*, 131 Ill.2d

509, 137 Ill. Dec. 554, 546 N.E.2d 499, 501-02 (1989). "The existence of a duty is a question of law to be determined by the court" (*Puckett*, 529 N.E.2d at 1172 (Knecht, J., dissenting; citation omitted)), but it remains "for the trier of fact to determine if that duty was breached." *Pippin v. Chicago Housing Authority*, 78 Ill.2d 204, 35 Ill. Dec. 530, 399 N.E.2d 596, 600 (1979).

Here the district court found Dean Witter had no duty to protect Harrison from the wrongdoing of its employees, Kenning and Carpenter. Thus, the court entered judgment as a matter of law in favor of Dean Witter. We review *de novo* (*Salve Regina College v. Russell*, 111 S. Ct. 1217 (1991)) and agree that Dean Witter did not owe Harrison the common-law duty claimed.

Illinois courts have regularly held that, for a duty of care to exist, the plaintiff and defendant must stand "in such a relationship to one another that the law impose[s] upon the defendant an obligation of reasonable conduct for the benefit of the plaintiff." *McLane*, 546 N.E.2d at 502. Illinois courts have found a claim of negligent hiring and retention adequately stated, reversed a dismissal or summary judgment for the defendant, or affirmed a verdict for the plaintiff where the following relationships existed:[7] (1) the plaintiff is an employee of the defendant (*Tatham*, 107 N.E.2d 735); (2) the plaintiff contracted for

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[7] In *Malorney v. B & L Motor Freight, Inc.*, 146 Ill. App. 3d 265, 100 Ill. Dec. 21, 496 N.E.2d 1086, 1089 (1st Dist. 1986) (17-year-old plaintiff-hitchhiker repeatedly raped and assaulted in sleeper cab of truck by its driver), the court found the employer had a "duty to hire a competent driver who was to be entrusted with a . . . [sleeper-equipped,] over-the-road truck" and, accordingly, affirmed the trial court's denial of defendant's motion for summary judgment. The duty found in *Malorney* was based in part on the observation that truck drivers "are prone to give rides to hitchhikers despite rules [to the contrary]" and incorporated the concept of entrustment. *Id.* at 1089. Harrison has raised neither the issue of widespread propensity to violate brokerage-house rules nor the issue of entrustment.

defendant's services (*Becken*, 532 F.2d 56; *Easley v. Apollo Detective Agency, Inc.*, 69 Ill. App. 3d 920, 26 Ill. Dec. 313, 387 N.E.2d 1241 (1st Dist. 1979) (tenant raped by guard employed by agency employed by landlord to provide security)); (3) the plaintiff is the defendant landlord's tenant or the social guest of a tenant (*Pippin*, 399 N.E.2d 596; *Cross v. Wells Fargo Alarm Services*, 82 Ill.2d 313, 45 Ill. Dec. 121, 412 N.E.2d 472 (1980); *Phillips v. Chicago Housing Authority*, 89 Ill.2d 122, 59 Ill. Dec. 281, 431 N.E.2d 1038 (1982)); and (4) the plaintiff is the social guest of the defendant host (*Gregor v. Kleiser*, 111 Ill. App. 3d 333, 67 Ill. Dec. 38, 443 N.E.2d 1162 (2nd Dist. 1982)). Additionally, we have noted that while Illinois does not generally

> impose a duty to protect others from criminal attacks [(and, we might now add, acts)] by third parties, . . . the Illinois courts have recognized exceptions to this rule where the criminal attack was reasonably foreseeable and the parties had a 'special relationship:' (1) carrier-passenger, (2) innkeeper-guest, (3) business invitor-invitee, or (4) voluntary custodian-protectee.

Figueroa v. Evangelical Covenant Church, 879 F.2d 1427, 1430 (7th Cir. 1989) (citations omitted).

The undisputed facts show no special, duty-creating relationship existed between Dean Witter and Harrison. Harrison had no account at Dean Witter. Moreover, no alleged fact indicates he was ever a customer of, had ever purchased a security from, or had ever placed an investment with the Boca Raton branch of Dean Witter. Thus, even if Dean Witter were negligent in hiring and retaining Kenning or Carpenter, no duty arose under the circumstances here.

RULE 11 SANCTIONS

The district court imposed sanctions under Fed. R. Civ. P. 11 on Harrison's attorney, Thomas P. Ward, in the amount of $20,860.50 in attorney's fees for raising two frivolous claims: Count III, the claim under Section 1962(c)

of RICO, which the court dismissed early on, and Count V, the claim on the promissory notes. Dean Witter had sought sanctions on the other counts, too, claiming all were frivolous, but the court declined. Both Harrison and Dean Witter appealed.

Dean Witter points out that Harrison did not name Ward as an appellant in its notice of appeal, otherwise timely filed on March 1, 1991, and argues that under *Torres v. Oakland Scavenger Co.*, 487 U.S. 312 (1988), we lack jurisdiction on this portion of the appeal for appellants' failure to comply with the requirement of Fed. R. App. P. 3(c). That rule states, "The notice of appeal shall specify the party or parties taking the appeal . . . ." *Torres*, 487 U.S. at 314, held, "The failure to name a party in a notice of appeal is more than excusable 'informality'; it constitutes a failure of that party to appeal." While Fed. R. App. P. 3(c) also provides, "An appeal shall not be dismissed for informality of form or title of the notice of appeal," it was of no avail to the party in *Torres*: "But although a court may construe the Rules liberally in determining whether they have been complied with, it may not waive the jurisdictional requirements of Rules 3 and 4, even for 'good cause shown' under Rule 2, if it finds that they have not been met." *Torres*, 487 U.S. at 317.

We have stated, "*Torres* made the requirements of Rule 3(c) inflexible." *FTC v. Amy Travel Service, Inc.*, 875 F.2d 564, 577 (7th Cir.), *cert. denied*, 493 U.S. 954 (1989). We have no jurisdiction over an appeal or that part of an appeal where the party taking the appeal is not named in the notice of appeal. *Id.* Because attorneys sanctioned by the district court are the real parties in interest, "the attorneys must appeal in their own names." *Rogers v. National Union Fire Insurance Co.*, 864 F.2d 557, 560 (7th Cir. 1988) (citation omitted). This attorney Ward did not do.

Appellants argue, however, that upon discovery of this error they filed a motion to amend the notice of appeal under Fed. R. App. P. 27. They find support for our granting their motion in a statement in *Torres* that the party

there had not sought to amend the defective notice of appeal. The *Torres* Court actually stated, "Nor did petitioner seek leave to amend the notice of appeal within the time limits set by Rule 4." *Torres*, 487 U.S. at 317. Fed. R. App. P. 4(a)(1) requires the notice of appeal be filed within "30 days after the date of entry of the judgment or order appealed from . . . ." Rule 4(a)(5) permits the district court to

> extend the time for filing of a notice of appeal upon motion filed not later than 30 days after the expiration of the time prescribed by this Rule 4(a). . . . No such extension shall exceed 30 days past such prescribed time or 10 days from the date of entry of the order granting the motion, whichever occurs later.

As made clear in *United States ex rel. Leonard v. O'Leary*, 788 F.2d 1238, 1239 (7th Cir. 1986), Rule 4(a)(5) grants a grace period of no more than thirty days beyond the initial 30-day deadline. Here appellants' motion to amend was filed June 10, 1991, 124 days after the entry of final judgment on February 6, 1991, 101 days after the errant notice of appeal was filed, and 94 days after the last day to file its notice of appeal, which under Rule 4(a)(1) was March 8, 1991. Appellants did not seek to amend their notice of appeal "within the time limits set by Rule 4." Accordingly, we have jurisdiction over neither their motion to amend nor that portion of the appeal challenging the district court's imposition of Rule 11 sanctions on attorney Ward.

On cross-appeal Dean Witter, citing Fed. R. Civ. P. 11 and 28 U.S.C. § 1927, argues it was improperly denied sanctions in the form of attorney's fees on the other claims raised by Harrison: namely, Counts I, II, IV, and VI through XII. Whether to award sanctions is within the discretion of the district court, and, accordingly, we review the district court's decision only for abuse of discretion. *Cooter & Gell v. Hartmarx Corp.*, 496 U.S. 384, 405 (1990); *Kotsilieris v. Chalmers*, 966 F.2d 1181, 1183 (7th Cir. 1992).

Dean Witter first argues that it was denied a proper hearing on its motion for sanctions because the motion was heard by a judge other than the one that handled earlier aspects of the case, including defendant's motion for summary judgment. Dean Witter does not, however, find the sanctions that were awarded by this latter judge similarly tainted. The contention, without more, is clearly without merit. *See Automatic Liquid Packaging, Inc. v. Dominik*, 909 F.2d 1001, 1006 (7th Cir. 1990) (In deciding a Rule 11 motion, it is not improper for a district court judge to rely on events that occurred before another judge and that are discoverable only by reviewing the record.).

In a carefully detailed, well reasoned opinion, Judge Lindberg found that, except for Counts III and V, Harrison's claims were neither frivolous nor raised for improper purposes. The court observed that, although the law was otherwise, Dean Witter seemed to argue that its having won the summary judgment motion proved the plaintiffs had not conducted a reasonable inquiry into the law and the facts. *See Mars Steel Corp. v. Continental Bank N.A.*, 880 F.2d 928, 932 (7th Cir. 1989) (en banc) ("Rule 11 focuses on inputs rather than outputs, conduct rather than results."), and *Prochotsky v. Baker & McKenzie*, 966 F.2d 333 (7th Cir. 1992) (district court's award of summary judgment for defendant and concomitant denial of Rule 11 sanctions affirmed). Dean Witter raises the same, impecunious argument here, and others, too. We have carefully reviewed the district court's findings and the record. We cannot find that the district court abused its discretion, and, therefore, we affirm its partial denial of sanctions.

Lastly, claiming Harrison's appeal of sanctions was frivolous because of the obvious, undisputable jurisdictional bar, Dean Witter asks for sanctions under Fed. R. App. P. 38. Dean Witter points out that it had advised attorney Ward by letter, long ago, both of the jurisdictional bar and that it would seek sanctions if he persisted. He, ob-

viously, persisted, but we deny Dean Witter's motion. The appeal was not frivolous.

CONCLUSION

We reverse the district court's grant of summary judgment with respect to the claim raised under Section 20(a) of the Securities Exchange Act of 1934 and remand for further proceedings, but we affirm the remainder of the district court's judgments and orders. For want of jurisdiction, we dismiss appellants' appeal on the imposition of Rule 11 sanctions.

Parties shall bear their own costs.

AFFIRMED IN PART,
REVERSED IN PART AND REMANDED,
and DISMISSED IN PART.

A true Copy:

Teste:

Clerk of the United States Court of Appeals for the Seventh Circuit

UNITED STATES COURT OF APPEALS
For the Seventh Circuit
Chicago, Illinois 60604

JUDGMENT – WITH ORAL ARGUMENT

Date: September 8, 1992

Before:

Honorable MICHAEL S. KANNE, Circuit Judge
Honorable HARLINGTON WOOD, JR., Senior Circuit Judge
Honorable ALLEN SHARP, District Judge*

Nos. 91-1458 and 91-1592

HUDSON T. HARRISON and HARRISON CONSTRUCTION, INCORPORATED, a corporation,

Plaintiffs-Appellants,
Cross-Appellees,

v.

DEAN WITTER REYNOLDS, INCORPORATED, a corporation,

Defendant-Appellee,
Cross-Appellant.

Appeals from the United States District Court
for the Northern District of Illinois, Eastern Division.
No. 86 C 8003—Judge George W. Lindberg,
and Judge Brian Barnett Duff.

This cause was heard on the record from the above mentioned District Court, and was argued by counsel.

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* The Honorable Allen Sharp, Chief Judge, United States District Court for the Northern District of Indiana, sitting by designation.

On consideration whereof, IT IS ORDERED AND ADJUDGED by this court that the district court's grant of summary judgment with respect to the claim raised under Section 20(a) of the Securities Exchange Act of 1934 is REVERSED and REMANDED for further proceedings, but the remainder of the district court's judgments and orders are AFFIRMED. The appellant's appeal on the imposition of Rule 11 sanctions is DISMISSED for want of jurisdiction. Parties shall bear their own costs. The above is in accordance with the decision of this court entered this date.

APPENDIX B

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

No. 86 8003

HUDSON T. HARRISON and HARRISON CONSTRUCTION, INC., a corporation,

Plaintiffs,

v.

DEAN WITTER REYNOLDS, INC., a corporation, JOHN M. CARPENTER, and JOHN G. KENNING,

Defendants.

MEMORANDUM OPINION

Plaintiffs Hudson T. Harrison and Hudson T. Harrison, Inc. have sued Dean Witter Reynolds, Inc. ("Dean Witter") and two of its broker-dealers, John M. Carpenter and John G. Kenning, under §10(b) of the Securities Exchange Act of 1934 ("the Securities Exchange Act"), 15 U.S.C. §78j(b) ("§10(b)"), §20(a) of the Securities Exchange Act, 15 U.S.C. §78t(a) (§20(a)"), the Racketeer Influenced and Corrupt Organizations Act ("RICO"), 18 U.S.C. §§1961 et seq., and a number of state laws. Dean Witter has moved for summary judgment on all claims.

DISCUSSION

This case contains two stories. The first story is about Dean Witter, and how it allowed Kenning and Carpenter

to use its name and its office as part of a massive scheme to defraud investors. The second story is about Harrison, about how he threw millions of dollars at Kenning and Carpenter in the hopes of securing spectacular returns with no risk, and found himself millions of dollars poorer for his greed. Viewing all facts most favorably for Harrison, here's what happened.

Dean Witter's Story

Dean Witter's story begins back in mid-1983, when Kenning and Carpenter left the employ of a Florida branch of Prudential-Bache Securities, Inc. under questionable circumstances involving a failed complex securities transaction. Within weeks, a Dean Witter Florida branch office hired the two after conducting an investigation into the affair and after the New York Stock Exchange approved Kenning's application for transfer of his broker-dealer registration.

Richard Frost, the local Dean Witter branch manager, made Kenning a vice president and account executive. Carpenter, who was not registered, became Kenning's assistant and established an account in his own name at Dean Witter. Kenning controlled the account, and had Carpenter establish it primarily because Kenning was facing bankruptcy. Frost's signature was required on any order ticket for the account.

Carpenter and Kenning soon began accumulating huge sums in Carpenter's account by soliciting clients to become involved in municipal bond deals. They told their clients that the funds would be pooled and used to purchase these low risk bonds at substantially reduced prices and commissions—discounts available, they said, because they were Dean Witter employees and because of the

large sums of money involved. As it turns out, however, Carpenter and Kenning did not invest in municipal bonds at all, but instead in high-risk put options.

Not only were Carpenter and Kenning lying about what they were doing, but they were blatantly violating Dean Witter rules prohibiting employees from commingling their own funds with client funds and from sharing an interest in an account with anyone other than a close relative. By August, 1984, Carpenter and Kenning had displayed an uncanny ability for losing money, having amassed nearly $600,000 in losses since starting with Dean Witter. In August, Dean Witter's regional manager, Haskell Adler, met with Kenning's former Prudential-Bache supervisor, who informed Adler that Kenning could not be trusted. Adler did nothing with the information.

In addition, on a number of occasions Alfred Rauschman, the head of Dean Witter's compliance department, contacted Frost to inquire about the heavy volume of trading taking place in Carpenter's account. Dean Witter's internal rules require supervisors to ensure that an employee's investments are commensurate with his resources. Frost questioned Carpenter and Kenning about their activities, but when Carpenter explained that the money was his own, Frost looked no further, demanding only that Carpenter have cash on hand for every purchase he made. Although Dean Witter rules prohibit employees from receiving checks in their own names, and require branch managers to screen all incoming and outgoing correspondences, Carpenter and Kenning avoided discovery of their scheme by having their clients send them money either at home or to their personal bank accounts.

By June, 1986, Kenning and Carpenter had amassed losses of more than $2,000,000 in the Carpenter account,

as well as having paid substantial commissions to Dean Witter for the thousands of trades they had made. At this point, the house came tumbling down, with Kenning and Carpenter admitting their wrongdoing to their clients as well as Dean Witter.

Harrison's Story

Harrison's story begins in February, 1985, with Kenning and Carpenter still actively engaged in their fraudulent scheme. At this time, Harrison, an Illinois millionaire with considerable investment experience, traveled to Florida with his friend, John Cahoon. There he met Carpenter for the first time and stayed at Carpenter's home. During the trip, Cahoon and Carpenter mentioned the bond deals which Carpenter and Kenning were offering to their larger clients. Before leaving Florida, Harrison expressed an interest in the deals.

Upon returning to Illinois, Harrison received a call from Kenning or Carpenter asking him if he wanted to participate in the bond deals. Over the next few weeks, the two Dean Witter employees spoke with Harrison on a number of occasions and explained that the bond deals would require Harrison to provide Kenning and Carpenter with funds which they would then place in their own accounts at Dean Witter. They would use these funds to purchase municipal bonds, nearing maturity, at a substantial discount. Harrison would earn some interest in the period before maturity, and then a large gain when the bonds were redeemed at par value. The discounts, the two told Harrison, were not available in transactions out of a customer's account.

Harrison made his first investment of $200,000 with Kenning and Carpenter on February 28, 1985, and over

the next 16 months, 15 additional investments totaling approximately $2.8 million. Harrison also made two investments, totaling $1.1 million, out of HCI funds. At Carpenter's request, Harrison made two of these investments by wire transfer to Carpenter's personal checking account, and the rest by mailing checks to Carpenter at his home address.

In return for the investments, Carpenter and Kenning provided Harrison with what were fashioned to be personal promissory notes, but which Harrison believed were receipts for his bond purchases. The due dates of the notes generally coincided with the due dates of the bonds. The notes provided for Harrison to receive at the due date an interest rate commensurate with the return Harrison expected to receive on the bond deals. On an annualized basis, these notes contained interest rates ranging from approximately 18% to 60%. Dean Witter's name did not appear on any of the notes, and Harrison never received any confirmation or statement from Dean Witter regarding his investments with Kenning and Carpenter.

Through July, 1986 Carpenter repaid out of his personal checking account and in cash approximately $800,000 to Harrison and HCI. Harrison believed these payments represented profit generated from his interest in the municipal bonds, though Carpenter provided him with tax forms stating that Harrison and HCI had received interest income from Carpenter. Harrison also declared $46,296.51 on his 1985 tax return as interest income on the monies he had given Carpenter for bond investments during 1985.

In July, 1986, Carpenter and Kenning flew to Illinois to inform Harrison that they had lost all of Harrison's money. When Harrison asked how they could have suffered such losses in municipal bonds, Carpenter informed him

that they had been investing his money in far riskier instruments. Carpenter offered to establish a plan for repaying Harrison, but when he failed to produce such a plan in writing, Harrison sent letters to Carpenter and Kenning demanding immediate payment of all money due himself and HCI. Harrison did not notify Dean Witter of his losses, nor demand payment from Dean Witter, until he filed his lawsuit.

DISCUSSION

Of the 11 counts remaining in Harrison's 12-count first amended complaint,[1] nine—one §10(b) claim, one RICO claim, and seven state law claims[2]—seek to impose liability against Dean Witter vicariously for the acts of Kenning and Carpenter. One claim, a negligence claim, alleges that Dean Witter itself—that is, Dean Witter's management level personnel, *see D&S Auto Parts, Inc.* v. *Schwartz*, 838 F.2d 964, 967-68 n.5 (7th Cir. 1988)—violated Harrison's rights. And one claim, a §20(a) claim, involves a combination of the two. The court will address these theories of liability seriatim, cognizant of the fact that it may grant summary judgment for Dean Witter only if there remain no genuine issues of material fact requiring trial. Fed.R. Civ.P. 56(c).

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[1] In an earlier ruling, this court dismissed one of Harrison's two RICO claims, a §1962(c) claim, on the grounds that Dean Witter could not be held liable vicariously under this subsection for the acts of lower level employees such as Carpenter and Kenning. *Harrison* v. *Dean Witter Reynolds, Inc.*, No. 86 C 8003, slip op. (N.D. Ill. Sept. 9, 1988).

[2] The seven state law claims include: default on promissory notes; common law fraud; breach of fiduciary duty; breach of contract; breach of covenant of good faith; conversion; and violation of Florida law.

Respondeat Superior

Dean Witter does not deny that Kenning and Carpenter engaged in numerous illegal acts during the course of their employment with the securities firm. Under the common law doctrine of respondeat superior, Harrison may hold Dean Witter vicariously liable—that it, liable without fault—for its employees' violations of §10(b),[3] RICO,[4] and state law, provided that he can show either that Kenning and Carpenter had actually authority to do what they did, or that the two had the apparent authority to do it. *See generally Rosenthal & Co.* v. *Commodity Futures Trading Commission*, 802 F.2d 963 (7th Cir. 1986).[5] Whether they had such authority is a " '[question] of fact, to be decided by the trier of fact,' unless the relationship [or absence thereof] is 'so clear as to be undisputed.' " *Rankow* v. *First Chicago Corp.*, 870 F.2d 356,

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[3] Because §20(a) provides for a form of vicarious liability against securities firms, *see post* at [50-54], some courts have held that §20(a) precludes the application of common law respondeat superior. *See generally* Fitzpatrick & Carman, Respondeat Superior and the Federal Securities Laws: A Round Peg in a Square Hole, 12 Hofstra L.Rev. 1 (1983). The Seventh Circuit, however, has held that both §20(a) and common law vicarious liability principles apply in securities fraud cases. *Henrickson* v. *Henrickson*, 640 F.2d 880, 887 (7th Cir. 1981).

[4] In this court's earlier ruling, it was noted that the Seventh Circuit has created some ambiguity as to whether vicarious liability applies to §1962(a) claims. The court need not pursue this matter since, even if vicarious liability is available, Harrison cannot obtain it here.

[5] Although Dean Witter's vicarious liability for the state law claims is governed by Illinois law, whereas its vicarious liability under the federal claims would presumably be determined by federal principles, this court (as did the parties) will rely on federal and state cases interchangeably inasmuch as there is no discernible distinction among them on the legal issues presented here.

359 (7th Cir. 1989) (quoting *St. Ann's Home for the Aged* v. *Daniels*, 95 Ill.App.3d 576, 579 (1981)).

a. *Actual Authority*

Harrison first argues that Dean Witter may be held liable for the acts of Kenning and Carpenter because the two were authorized to sell municipal bonds to customers and that is precisely what they were doing. The fact that they subsequently misused the funds, Harrison contends, does not alter the fact that Kenning and Carpenter were doing what they were authorized to do.

Of course, Kenning and Carpenter were not really selling municipal bonds at all. But that is what they were offering to Harrison, and that is what he thought he was purchasing. Under settled principles of respondeat superior, an employee who does what he is authorized to do binds his employer even if the employee acts with an improper purpose and ultimately cheats both his employer and the third person. Restatement (Second) of Agency §165, Comment e; *id.* at §257, Comments a, d; *see Congregation of the Passion, Holy Cross* v. *Kidder Peabody & Co., Inc.*, 800 F.2d 177, 184 (7th Cir. 1986).

The flaw in Harrison's position, however, lies in the fact that Kenning and Carpenter were not authorized to sell municipal bonds in the manner they (purportedly) were selling them to Harrison, for Dean Witter's internal rules forbid employees from commingling their own funds with those of customers and from using customer funds to make purchases out of employee accounts. Had Dean Witter authorized its employees to offer bond deals of the sort Kenning and Carpenter were offering, it could not have escaped liability when the two misused Harrison's money. But because Dean Witter expressly prohibited

these types of deals, Harrison cannot prevail under the principles of §165.

Still, the actual authority prong of the doctrine of respondeat superior goes further than §165. An employer is liable not only for acts it specifically authorizes its employee to do, but also for the acts of an employee within the scope of his employment. Restatement (Second) of Agency, §§216, 219(1); *see also Henrickson* v. *Henrickson*, 640 F.2d 880, 887-88 (7th Cir. 1981); *Lynch* v. *Board of Education*, 82 Ill.2d 415, 424-25 (1980).

In cases involving intentional wrongdoing, the scope of employment doctrine acquires something of an abstract quality, for such wrongdoing is never really within the scope of an employee's employment: if it were, then the employer's liability would be direct, not vicarious. *See* Restatement (Second) of Agency, §212 & Comment a; *cf. Pomer* v. *Deere & Co.*, No. 88-1794, slip op. at 7 (7th Cir. May 12, 1989). In determining whether an employer is liable for the wrongdoing of an employee, the analysis becomes one of degree: Just how related must the wrongdoing be to the nature of the employee's work before the wrongdoing itself falls within the scope of the employment?

In defining the boundaries of this doctrine, courts have looked to the rationales for it. These include: the equity consideration that the employer obtains benefits from the employee's legitimate work and thus should pay when the employee goes astray; the deterrence objective of providing employers with the incentive to keep their employees in line; and the compensatory function of imposing liability on the one, as between the innocent injured and the innocent employer, who can best absorb the costs of the employee's wrong. *See* W. Keeton, D. Dobbs, R. Keeton

& D. Owen, *Prosser on Torts* §69, at 500-01 (5th ed. 1984); Restatement (Second) of Agency, §217, Comment a. The general rule is that an employee acts within the scope of his employment for respondeat superior purposes when his conduct "(a) . . . is of the kind he is employed to perform; (b) . . . occurs substantially within the authorized time and space limits; [and] (c) . . . is actuated, at least in part, by a purpose to serve the master . . . ." Restatement (Second) of Agency, §228; *Prosser on Torts*, *supra*, §70 at 502.

A jury could find that the acts of Carpenter and Kenning were of the kind they were hired to perform. Unlike §165, which provides for liability only when the act is specifically authorized by the employer, §229 of the Restatement provides that an act is of the kind an employee was hired to perform if the act is similar to those he was authorized to do and *inter alia*, if the employer "has reason to expect that such an act will be done." Restatement (Second) of Agency, §229(f); *see Rosenthal & Co.* v. *Commodity Futures Trading Commission*, 802 F.2d at 968-69. Thus, an act may be within the scope of employment even if it was specifically prohibited by the employer. Restatement (Second) of Agency, §230 ("An act, although forbidden, or done in a forbidden manner, may be within the scope of employment.");[6] *see Marbury Man-*

[6] Dean Witter's reliance on *Old Security Life Insurance Company* v. *Continental Illinois National Bank*, 740 F.2d 1384 (7th Cir. 1984), proves only partially helpful here. Although the Seventh Circuit there stated that "[a]n agent has no authority to act contrary to the known wishes and instructions of his principal," *id.* at 1391, that case involved a contract-type claim and thus was subject to different vicarious liability standards than apply in cases involving tortious conduct. Thus, while the case does assist Dean Witter with respect to Harrison's contractual claims, it does not protect Dean Witter on the bulk of Harrison's complaint.

agement, Inc. v. *Kohn*, 629 F.2d 705, 716 (2d Cir. 1980). Dean Witter hired Kenning and Carpenter to sell securities, and the facts suggest that it closed its eyes to the brokers' use of customer funds out of Carpenter's account.[7] These facts weigh in favor of finding the brokers' activities here to be within the scope of their employment.

What saves Dean Witter are the second and third elements in the analysis. Though Carpenter and Kenning received telephone calls at their office from Harrison, their relationship with Harrison took place primarily outside the office. Most significant, they received checks from him at home, received wire transfers to their personal bank accounts, and intentionally sought to avoid the oversight of Dean Witter supervisors. *See* Restatement (Second) of Agency, §234; *cf. Bolwin* v. *El Kay Manufacturing Co.*, 32 Ill.App.3d 138 (1975) (no respondeat superior liability where agency relationship was temporarily discontinued when tort occurred). Likewise, while Kenning and Carpenter paid commissions to Dean Witter out of the purchases they made with Harrison's money, no reasonable jury could find that they sought through their activities to benefit Dean Witter. On the contrary, their actions demonstrate a conscious plot to prevent Harrison from becoming a Dean Witter customer, and to use Harrison's funds for their own purposes. *See* Restatement (Second) of Agency, §235; Notes, Rule 10b-5—The Equivalent Scope of Liability under Respondeat Superior and Section 20(a)—

[7] Although Dean Witter's alleged negligence in not properly supervising Kenning and Carpenter is not relevant to the *respondeat superior* theories, the facts underlying this claim are relevant to the scope of the brokers' authority. A jury could find that Frost's minimal efforts to detect the source of their funds led them to believe that Dean Witter really did not care from where they got their money so long as they paid cash for each option purchase.

Imposing a Benefit Requirement on Apparent Authority, 35 Vand.L.Rev. 1383, 1398 (1982) ("proper focus is upon the employee's state of mind"). Thus, even if a jury could find that the fraudulent scheme involved some activities of the kind Kenning and Carpenter were permitted to perform, it could not find that they were acting within the scope of their employment in the conduct of this scheme.

B. *Apparent Authority*

When an employee acts outside the scope of his actual authority, his actions still may bind his employer if the employer "create[s] an appearance that the acts are authorized." *Rosenthal & Co.* v. *Commodity Futures Trading Commission*, 802 F.2d at 966. Actual authority depends on the employer's relationship with the employee. Apparent authority, by contrast, turns on the employer's relationship with the injured. Where the employer's actions give the injured reason to believe that the employee is acting within his authority, the employer is bound by the employee's acts even if the employee actually lacked such authority. *See American Society of Mechanical Engineers, Inc.* v. *Hydrolevel Corp.*, 456 U.S. 556, 565-68 (1982); Restatement (Second) of Agency, §261.

Harrison argues that Kenning and Carpenter had the apparent authority to offer the municipal bond deals on behalf of Dean Witter because they were Dean Witter employees, because they provided Harrison with a Dean Witter phone number at which to contact them, and because Dean Witter allowed the scheme to continue for a substantial period of time without notifying Harrison that something was amiss. He notes that an employer need have had no direct contact with the injured, so long as the authority he granted the employee reasonably sug-

gest that the employee had the authority to do the unauthorized acts. *See Alterman* v. *Lydick*, 241 F.2d 50, 53 (7th Cir. 1957).

All this being true, Harrison cannot escape summary judgment here. An underlying predicate of any apparent authority theory is that " 'from the point of view of the third person the transaction seems regular on its face and the agent appears to be acting in the ordinary course of the business confided to him.' " *American Society of Mechanical Engineers, Inc.* v. *Hydrolevel Corp.*, 456 U.S. at 566 (1982) (quoting Restatement (Second) of Agency, §261, Comment a, p. 551). Apparent authority is an equitable doctrine designed to prevent injury to an innocent injured. When an individual has notice that an employee is exceeding the scope of his authority, the individual cannot rely on the employee's manifestations alone and then claim apparent authority. Restatement (Second) of Agency, §262 & Comment c; *see Holloway* v. *Howerdd*, 536 F.2d 690, 696 (6th Cir. 1976). He must undertake some reasonable efforts to determine whether the employee has the authority he says he does. *Evanston Bank* v. *Conticommodity Service, Inc.*, 623 F.Supp. 1014, 1032 (N.D. Ill. 1985).

Harrison's transactions with Kenning and Carpenter were anything but regular. Kenning and Carpenter told him that he could not open an account with Dean Witter, that he should mail or wire all payments to them personally, and that he would be receiving discounts available only to Dean Witter employees. Further, Harrison never received a single receipt, statement or other communication bearing a Dean Witter heading or the signature of anyone at Dean Witter. Thus, even if Harrison truly believed that he was a Dean Witter customer (and

this much is open to serious question), he had an obligation to inquire further into the authority of Kenning and Carpenter to offer the bond deals on Dean Witter's behalf. Since he concedes that he did not do so, no reasonable jury could find Dean Witter liable under an apparent authority theory. Dean Witter is entitled to summary judgment on Harrison's respondeat superior claims.

Negligence

Harrison predicates his negligence claim on Dean Witter's hiring and supervising of Kenning and Carpenter. According to Harrison, Dean Witter never should have hired the two brokers, and once it did, the firm should have supervised them to prevent them from defrauding Dean Witter customers. Dean Witter has moved for summary judgment on two grounds: that the Illinois economic loss doctrine precludes Harrison from bringing a negligence claim for his losses, and that, in any case, Dean Witter had no duty to Harrison because he was not a Dean Witter customer.

a. *The Economic Loss Doctrine*

Dean Witter contends that Harrison may not pursue his negligence claim because he seeks to recover purely economic losses—i.e., the money he invested with Carpenter and Kenning plus interest—and Illinois prohibits suing in tort for such losses. Harrison disagrees, arguing that the Illinois economic loss doctrine does not apply to the negligent performance of professional services.[8]

[8] Harrison also makes two other arguments against the application of the economic loss doctrine here, but neither merits much

(Footnote continued on following page)

In *Moorman* v. *National Tea Company*, 91 Ill.2d 69 (1982), the plaintiff sued the manufacturer under strict liability, innocent misrepresentation, and negligence when a steel grain storage tank developed a large crack. The Illinois Supreme Court dismissed all three claims, holding that a plaintiff suing for economic losses—i.e., " 'damages for inadequate value, costs of repair and replacement of the defective product, or consequent loss of profits—without any claim of personal injury or damage to other property,' " *id.* at 82 (quoting Note, Economic Loss in Products Liability Jurisprudence, 66 Colum.L.Rev. 917, 918 (1966)—generally must bring his claims in contract rather than tort. The Court, however, noted two kinds of cases in which the recovery of economic loss had been permitted: "where one intentionally makes false representations (*Soules* v. *General Motors Corp.*, 79 Ill.2d 282 (1980)), and where one who is in the business of supplying information for the guidance of others in their business transactions makes negligent representations. (*Rozny* v. *Marnul*, 43 Ill.2d 54)." *Moorman*, 91 Ill.2d at 88-89.

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[8] *continued*

discussion. First, he argues (without citation) that he is seeking damages beyond mere economic loss because, in addition to profits, he requests the recovery of funds invested with Dean Witter. Yet, *Rankow* v. *First Chicago Corp.*, 870 F.2d 356 (7th Cir. 1989), held that precisely such damages were economic losses within the scope of the doctrine. *See also First National Bank of Boston* v. *Hitoshi Une*, No. 87 C 10831, 1988 U.S.Dist LEXIS 13416 (N.D. Ill. 1988) (money extended as credit, both principal and interest, fall within economic loss doctrine); *Bane* v. *Ferguson*, 707 F.Supp. 988, 998 (N.D. Ill. 1989). Second, he argues that claims of negligent misrepresentations against those in the business of supplying information do not fall within the doctrine. This is true (see the discussion in the text below), but does not help Harrison since he is not suing Dean Witter for making negligent misrepresentations.

Moorman was a products liability action, and was predicated, at least in part, on the extensive framework the Uniform Commercial Code provides for dealing with economic losses caused by defective products (*see id.* at 78-79, 88). But after the Court applied the doctrine to non-UCC cases, *see Redarowitz* v. *Ohlendorf*, 92 Ill.2d 171 (1982) (purchaser of a home could not sue the builder in tort for economic losses resulting from defects in the home's construction); *accord Morrow* v. *L.A. Goldschmidt Associates, Inc.*, 112 Ill.2d 87 (1986), a number of Illinois appellate courts read *Moorman* broadly as barring all tort claims for economic loss except those specifically excepted in *Moorman*. Since claims against professionals usually seek only economic loss—rarely does professional misconduct cause personal injury or property damage—these courts have barred most actions against professionals for negligent performance of their services. *See, e.g., People ex rel. Skinner* v. *Graham*, 170 Ill.App.3d 417 (4th Dist. 1988); *Bates & Rogers Construction Corp.* v. *North Shore Sanitary District*, 128 Ill.App.3d 962 (2d Dist. 1984), *aff'd on other grounds*, 109 Ill.2d 225 (1985).

This view of the economic loss doctrine derives from the Illinois Supreme Court's failure to tie its doctrine into the traditional elements of tort liability. To recover in tort, a plaintiff always has had to establish three things: duty; breach of duty; and damages. W. Keeton, D. Dobbs, R. Keeton & D. Owen, *Prosser on Torts* §30, at 164-65 (5th ed. 1984). Most courts, including the United States Supreme Court, have prohibited claims for economic loss on the ground that a manufacturer has no extra-contractual duty to prevent economic loss. *See East River Steamship Corp.* v. *Transamerica Delavel, Inc.*, 476 U.S. 858, 871 (1986). Had the Illinois Supreme Court framed the doctrine as such, it would have made clear that where the

law imposes extra-contractual duties, a breach of those duties can give to liability in tort even if the only losses are purely economic ones.

The Illinois Court, however, has not explained its doctrine in this way. Instead, it has suggested the prohibition on economic loss arises not because the defendant had no tort duty to avoid such loss, but simply because contract, rather than tort, provides a more appropriate framework for dealing with economic loss. This approach takes tort and contract as mutually exclusive, *see* Bertschy, The Economic Loss Doctrine in Illinois After *Moorman*, 71 Ill.B.J. 346, 351 (1983)—ignoring the fact that in some circumstances an individual's duties extend beyond the contours of his contractual relationship—and would bar most professional negligence claims. *See Anderson Electric Company, Inc.* v. *Ledbetter Erection Corporation*, 115 Ill.2d 146 (1986) (Simon, J., specially concurring) (criticizing majority's exclusive focus on the nature of the loss).

Of course, if the Illinois Supreme Court truly meant to preempt all tort claims for economic loss—except in the two classes of cases set forth in *Moorman*—then federal courts have no authority to overrule this approach in diversity cases. But the Court never actually has ruled that the doctrine extends to cases in which the defendant has extra-contractual duties, *see Bates & Rogers Construction Corp.* v. *North Shore Sanitary District*, 109 Ill.2d 225, 229 (1985) (declining to decide whether doctrine barred negligence claim against professional architect); *Ferenchak* v. *Village of Frankfort*, 105 Ill.2d 474, 479 (1985) (same for civil engineer), and two factors indicate that it did not intend for the doctrine to go that far.

First, the view that the two exceptions set forth in *Moorman*—i.e., claims of intentional misrepresentation,

and of negligent misrepresentation by those in the business of supplying information—are the exclusive exceptions to the doctrine provides no rationale for why they should be so. Any justification for these exceptions—for example, that even a manufacturer has a duty to avoid intentionally misrepresenting his product—implies that the exceptions are merely illustrative of a broader set of cases in which applying the doctrine would be inappropriate. *See, e.g., Waldinger Corp.* v. *CRS Group Engineers, Inc.*, 775 F.2d 781 (7th Cir. 1985) (*Moorman* does not bar claims for intentional interference with contractual relationship); *accord Santucci* v. *Baxter and Woodman*, 151 Ill.App.3d 547, 553 (1984).

Second, and more important, to hold that *Moorman* bars tort claims for economic loss even where the defendant has extra-contractual duties "would, simply by inference, effectively eliminate and stand squarely in conflict with the body of law defining the scope" of professional liability. *Rosos Litho Supply Corporation* v. *Hansen*, 123 Ill.App.3d 290, 295 (1st Dist. 1984). A number of Illinois and federal courts have declined to read *Moorman* that broadly for precisely this reason, *see id.*; *People ex rel. Skinner* v. *FGM, Inc.*, 166 Ill.App.3d 802 (5th Dist. 1988); *Kishwaukee Community Health Services Center* v. *Hospital Building and Equipment Co.*, 638 F.Supp. 1492 (N.D. Ill. 1986), and at least one Illinois Supreme Court case lends support to this view.

In *Pelham* v. *Griesheimer*, 92 Ill.2d 13 (1982), a case decided just a few months after *Moorman*, the Court made no mention of the economic loss doctrine in ruling that, under certain circumstances, a non-client could sue an attorney for negligence. *See also Ogle* v. *Fuiten*, 112 Ill.App.3d 1048 (4th Dist. 1983). Since the damages in such a case would almost always constitute economic loss, this

ruling strongly suggests that the Court did not even consider that the economic loss doctrine would serve as a bar to professional negligence claims. *See Dundee Cement Co.* v. *Chemical Laboratories, Inc.*, 712 F.2d 1166 (7th Cir. 1983).

Limited to their holdings, the Illinois Supreme Court's economic loss doctrine cases provide a coherent philosophical and practical statement regarding the duties of manufacturers and other providers of tangible products: Whereas they have a societal obligation to prevent physical injury and damage to other property, and a duty as well to refrain from intentional misrepresentations, their obligations with respect to their products are primarily contractual. *Cf. Pippin* v. *Chicago Housing Authority*, 78 Ill.2d 204, 209 (1979) (scope of duty in voluntary undertaking is limited by contractual relationship). To extend the doctrine to claims of professional negligence, however, deprives the doctrine of its coherence. Why a professional who violates his extra-contractual obligations should gain immunity from liability merely because the damage he causes is economic finds no explanation in the cases and stands at odds with long-established law. *See* Hnatt, Purely Economic Loss: A Standard for Recovery, 73 Iowa L. Rev. 1181, 1198 (1988). Absent a clear message from the Illinois Supreme Court, this court can find no basis for extending the doctrine this far. Because Dean Witter implicitly has conceded that it is a provider of professional services, *cf. Rankow* v. *First Chicago Corp.*, 870 F.2d 364-65 (7th Cir. 1989), it cannot escape liability on the basis alone that Harrison's losses were purely economic.

b. *Duty*

Dean Witter next argues that it is entitled to summary judgment because it had no duty to prevent harm—eco-

nomic or otherwise—to Harrison. Harrison has responded with evidence that Dean Witter knew or should have known that Kenning and Carpenter were investing out of Carpenter's personal account more money than the two could afford. In light of Kenning's prior problems at Prudential-Bache, this evidence creates a genuine factual dispute as to whether Dean Witter likewise should have been alerted to the possibility that Kenning and Carpenter wrongfully were obtaining funds from outside sources. Yet, even if Dean Witter knew that Kenning and Carpenter were committing fraud, this knowledge alone is not enough to subject it to liability; Dean Witter must have had a duty to intervene on Harrison's behalf. *Homer* v. *Pabst Brewing Co.*, 806 F.2d 119, 121 (7th Cir. 1987); *see generally* W. Keeton, D. Dobbs, R. Keeton & D. Owen, *Prosser on Torts* §53 (5th ed. 1984). Whether Dean Witter had such a duty is an issue of law. *Ferenchak* v. *Village of Frankfort*, 105 Ill.2d 474, 480 (1985).

Although the foreseeability of injury is an important consideration in determining whether one has a duty to act reasonably with respect to another, it is not alone. *Kirk* v. *Michael Rees Hospital & Medical Center*, 117 Ill.2d 507 (1987). Instead, four factors come into play: "(1) whether the occurrence or accident was foreseeable; (2) the likelihood of injury; (3) the magnitude of the burden of guarding against that injury from occurring; and (4) the consequence of placing that burden upon the defendant." *Salvi* v. *Montgomery Ward & Co.*, 140 Ill.App.3d 896 (1986); *Barnes* v. *Washington*, 56 Ill.2d 22, 29 (1973). In cases where it is alleged that one person failed to prevent a third person from doing harm to another, the last two factors usually take precedence over the first two. That is, while wrongdoing may be foreseeable, and injury likely, the law generally imposes no duty to prevent such

harm because the burden on the defendant of imposing such a duty outweighs the benefits of doing so. *See Heldt* v. *Brei*, 118 Ill.App.3d 798, 802 (1983); Restatement (Second) of Torts, §314; W. Keeton, D. Dobbs, R. Keeton & D. Owen, *Prosser on Torts* §56, at 376 (5th ed. 1984).

Every rule has exceptions; this rule has two. A person who knows or has reason to know that a third person may cause harm to another has an obligation to protect the other if (1) the person has a special relation with the third person or (2) the person has a special relation with the other. *See* Restatement (Second) of Torts §315; *generally* W. Keeton, D. Dobbs, R. Keeton & D. Owen, *Prosser on Torts* §56, at 383-85 (5th ed. 1984). In the employer-employee context, both exceptions may come into play: An employer may have a duty to prevent employee wrongdoing because of the employer's relationship with the employee, and it may have a duty to prevent such wrongdoing because of its relationship with certain members of the public—i.e., its customers.

Harrison fails to specify the basis for his allegation that Dean Witter had a duty to prevent Kenning and Carpenter from injuring him. Instead, he argues that Dean Witter had a broad duty to prevent any employee from harming any member of the public. This is not so. *See Capalbo* v. *Paine Webber, Inc.*, 672 F.Supp. 1048, 1054 (N.D. Ill. 1987).

The employee-employer relationship imposes a duty on an employer to prevent employee misconduct when the employee is located on employer's premises or using the employer's property in furtherance of the wrong. *See* Restatement (Second) of Torts §317; *Gregor* v. *Keliser*, 111 Ill.App.3d 333 (1983). The mere fact that an employer has knowledge of an employee's delinquent tendencies, however, does not impose a duty on the employer to fire or

otherwise sanction the employee so long as the employee does his thing outside the employer's premises and without the aid of the employer's property. *See* Restatement (Second) of Torts §317, Comment b; *Roberson* v. *Allied Foundry and Machinery Co.*, 447 So.2d 720 (Ala. 1984); *cf. Insurance Co. of North America* v. *Hewitt-Robbins, Inc.*, 13 Ill.App.3d 534 (1973).

Kenning and Carpenter committed their fraud without the use of Dean Witter property. They did not give Harrison a Dean Witter contract, did not provide him with Dean Witter receipts, and did not pay him with Dean Witter checks. Nor did the two commit the fraud on Dean Witter's premises: Although they conversed with Harrison over the phone from Dean Witter's offices, the fraud occurred when Harrison either mailed checks to their homes or wired money to their personal accounts. Dean Witter's relationship with the two therefore did not obligate it to discover and terminate their fraud on Harrison.

An employer also has a duty to prevent employee wrongdoing when the employer has a contractual relationship with a customer which facilitates the employee's wrong. *See generally* Restatement (Second) of Agency §213. Thus, for example, if an employer contracts to provide moving services to a customer, it may be liable if an employee robs the customer during the move. *Becken* v. *Manpower, Inc.*, 532 F.2d 56 (7th Cir. 1976). And if an employer undertakes to provide security services to a customer, the employer may be liable if its employees use the employer's special privileges to enter the premises as part of a burglary scheme. *International Distributing Corp.* v. *American Distributors*, 569 F.2d 136 (D.C. Cir. 1977); *see also Welsh Manufacturing, Division of Textron, Inc.* v. *Pinkerton's Inc.*, 474 A.2d 436 (R.I. 1984).

Dean Witter and Harrison, however, had no relationship. To be sure, Harrison may have believed that he was a Dean Witter customer, but Dean Witter's duty to control the activities of its employees vis-a-vis its customers extends only so far as its contract with those customers. As already discussed, Dean Witter did not have a contractual relationship with Harrison. It therefore had no obligation to protect them from the wrongdoing of Dean Witter employees. Accordingly, Dean Witter is entitled to summary judgment on Harrison's negligence claim.

Section 20(a)

In addition to *respondeat superior* and common law negligence, Congress has provided an alternative basis for imposing liability on securities firms in §10(b) claims. Section 20(a) of the Securities Exchange Act of 1934 provides:

> Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

15 U.S.C. §78t(a).

Liability under §20(a) is both broader and narrower than liability under common law *respondeat superior*. The controlled person need not be an employee or agent of the defendant for the defendant to be subject to liability for wrongdoing, so long as the defendant exercised some control over the wrongdoer with respect to the wrongful acts. *Christoffel* v. *E.F. Hutton & Co., Inc.*, 588 F.2d 665, 668 (9th Cir. 1978). On the other hand, §20(a), unlike

respondeat superior, allows the defendant to escape liability if it can show that it acted in good faith and did not induce the misconduct. *See generally* Notes, Rule 10b-5—The Equivalent Scope of Liability under Respondeat Superior and Section §20(a)—Imposing a Benefit Requirement on Apparent Authority, 35 Vand.L.Rev. 1383, 1400-04 (1982).

Before examining Dean Witter's potential liability under §20(a), it is first necessary to identify the underlying violation, since without such a primary violation there can be no secondary liability, *Bosio* v. *Norbay Securities*, 599 F.Supp. 1513, 1570 (E.D.N.Y. 1985), and since Dean Witter can be held liable only for the wrongful acts of Kenning and Carpenter over which it exercised control, *Sennott* v. *Rodman & Renshaw*, 474 F.2d 32, 39-40 (7th Cir. 1973).

Dean Witter begins by arguing that there was no §10(b) violation at all. Under §10(b), fraud is actionable only if it is "in connection with the purchase or sale of [a] security." 15 U.S.C. §78j(b)."[9] Dean Witter contends that the fraud here was not in connection with the purchase of municipal bonds because Kenning and Carpenter never

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[9] Section 10 provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange—
>
> . . .
>
> (b) To use or employ, in connection with the purchase and sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. §78j(b).

actually purchased the bonds. This case, Dean Witter says, involves a conversion of funds, nothing more, and conversion does not give rise to a §10(b) claim, *see Crummere* v. *Smith, Barney, Harris, Upham & Co., Inc.*, 624 F.Supp. 751, 755 (S.D.N.Y. 1985); *Smith* v. *Chicago Corp.*, 566 F.Supp 66 (N.D. Ill. 1983).

Harrison does not take issue with Dean Witter's argument on this score.[10] Instead, Harrison argues that the securities here were the promissory notes Kenning and Carpenter gave to Harrison when he provided them with funds to purchase municipal bonds. Dean Witter, though noting that Harrison's position marks a sharp shift from his earlier argument that the notes were nothing more than receipts, concedes that these notes are securities for §10(b) purchases.

Harrison's victory, however, is short-lived. Having established that Kenning and Carpenter committed fraud in connection with their sales of these notes, he now must show that Dean Witter exercised control over the two brokers with respect to these sales. This he cannot do.

Although *respondeat superior* and §20(a) are not coextensive, so that an employee may act outside the scope of his employment and yet still be a controlled person under §20(a), courts have agreed that employment alone does not bring every one of an employee's acts within the coverage of the statute. *See Carpenter* v. *Harris, Upham & Co.*, 594 F.2d 388 (4th Cir. 1979); *Christoffel* v. *E.F. Hutton & Co., Inc.*, 588 F.2d 665 (3d Cir. 1978);

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[10] Because of Harrison's implied concession, this court need not and does not decide whether Dean Witter is correct in arguing that Kenning and Carpenter did not violate §10(b) by investing in options rather than in municipal bonds.

cf. Barker v. *Henderson, Franklin, Starnes & Holt*, 797 F.2d 490 (7th Cir. 1986). Section 20(a) requires, at least, that the firm have the ability directly or indirectly to influence the employee's doing of the specific unlawful act—for example, to prohibit the act from taking place on the employer's property. Where the employee's wrongdoing involves acts unrelated to his employment, his employer cannot be held liable on the grounds alone that it could have fired him had it known of the wrongdoing. *Christoffel* v. *E.F. Hutton & Co., Inc.*, 588 F.2d 665, 669 (3d Cir. 1978); *see also Bradshaw* v. *Van Houten*, 601 F.Supp. 983, 986-87 (D. Ariz. 1985).

Dean Witter exercised no control over Kenning and Carpenter with respect to their sales of promissory notes. It did not know of these sales, nor could it have known of them, since Carpenter and Kenning structured their arrangement with Harrison to ensure that Harrison would not send any money to them at the office. Further, the sales were conducted in the names of Kenning and Carpenter alone; the payments on the notes were by Carpenter's personal checks; and Harrison never contacted Dean Witter to inquire about his investments.

Dean Witter had an obligation to supervise Kenning and Carpenter at the office. It had obligations to ensure that Dean Witter's customers were not being defrauded by the two brokers, and to investigate any signs of wrongdoing with regard to the brokers' job-related activities. But those obligations did not extend to the brokers' personal affairs. Harrison could have brought himself within the protections of §20(a) by insisting on receipts and statements bearing Dean Witter's name. Instead, he chose to enter into transactions which any reasonable person, indeed any rational person, would have to conclude were

personal transactions between himself and Kenning and Carpenter. Dean Witter's responsibilities under §20(a) simply did not reach that far. The firm is therefore entitled to summary judgment on Harrison's §20(a) claim.

CONCLUSION

Dean Witter's motion for summary judgment is granted on each count in the complaint. Judgment is entered for Dean Witter.

ENTER:

BRIAN BARNETT DUFF, JUDGE,
UNITED STATES DISTRICT COURT

DATE: June 21, 1989

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

Name of Assigned Judge: BRIAN BARNETT DUFF

Case Number: 86 C 8003 Date: June 21, 1989

Case Title: Hudson T. Harrison v.
Dean Witter Reynolds, Inc.

* * * * *

DOCKET ENTRY:

(1) ☐ Judgment is ordered as follows:

(2) ☑ [Other docket entry:]

Dean Witter's motion for summary judgment is granted on each count in the complaint. Judgment is entered for Dean Witter.

* * * * *

APPENDIX C

UNITED STATES COURT OF APPEALS
For the Seventh Circuit
Chicago, Illinois 60604

December 28, 1992

Before

Hon. MICHAEL S. KANNE, Circuit Judge
Hon. HARLINGTON WOOD, JR., Senior Circuit Judge
Hon. ALLEN SHARP, District Judge*

Nos. 91-1458 & 91-1592

HUDSON T. HARRISON and HARRISON CONSTRUCTION, INCORPORATED, a corporation,
Plaintiffs-Appellants, Cross-Appellees,

v.

DEAN WITTER REYNOLDS, INCORPORATED, a corporation,
Defendant-Appellee, Cross-Appellant.

Appeal from the United States District Court
for the Northern District of Illinois, Eastern Division.
No. 86 C 8003—Brian Barnett Duff, *Judge*,
and George W. Lindberg, *Judge*

---

* The Honorable Allen Sharp, Chief Judge, United States District Court for the Northern District of Indiana, sitting by designation.

ORDER

On consideration of the petition for rehearing with suggestion for rehearing in banc filed in the above-entitled cause by appellee-cross appellant on September 22, 1992, and petition for rehearing filed by the plaintiffs-appellants on September 22, 1992, all of the judges on the original panel having voted to deny the same,

IT IS HEREBY ORDERED that the aforesaid petition for rehearing with suggestion for rehearing in banc filed by appellee-cross appellant and the petition for rehearing filed by plaintiffs-appellants be, and the same are hereby, DENIED.

Supreme Court, U.S.
FILED
APR 29 1993
OFFICE OF THE CLERK

No. 92-1586

In The

Supreme Court of the United States

October Term, 1992

DEAN WITTER REYNOLDS, INC.,
a corporation,

Petitioner,

v.

HUDSON T. HARRISON and HARRISON CONSTRUCTION INCORPORATED, a corporation,

Respondents.

On Petition For Writ Of Certiorari To The United States Court Of Appeals For The Seventh Circuit

RESPONDENTS' BRIEF IN OPPOSITION

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QUESTIONS PRESENTED

1. Whether a broker-dealer may be held liable under Section 20(a) of the Securities Exchange Act of 1934 for acts of fraud perpetrated by registered salespersons operating from the broker dealer's office over a 30-month period where the registered salespersons:

   (a) represented to more than 100 investors that the broker-dealer permitted them to solicit and invest funds in a broker-dealer authorized program;

   (b) convinced these investors that those representations were true; and

   (c) applied the funds received from investors who relied on those representation to tens of thousands of highly speculative transactions over a period of nearly three years in the registered salespersons' personal accounts with the broker-dealer?

2. Whether a broker-dealer's claim of "good faith" may be established on its motion for summary judgment when plaintiff has shown the facts to be as described in Question 1.

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No. 92-1586

In The

Supreme Court of the United States

October Term, 1992

DEAN WITTER REYNOLDS, INC.,
a corporation,

Petitioner,

v.

HUDSON T. HARRISON and HARRISON CONSTRUCTION INCORPORATED, a corporation,

Respondents.

On Petition For Writ Of Certiorari To The United States Court Of Appeals For The Seventh Circuit

RESPONDENTS' BRIEF IN OPPOSITION

The opinion of the United States Court of Appeals for the Seventh Circuit is reported at 974 F.2d 873 (7th Cir. 1992). The opinion of the United States District Court for the Northern District of Illinois is reported a 715 F.Supp.

1425 (N.D. Ill. 1989). These opinions are included as Appendix A and B of Dean Witter's Petition.[1]

JURISDICTION

Petitioner has correctly stated the grounds on which it seeks to invoke the jurisdiction of the Supreme Court.

STATUTE INVOLVED

Section 20(a) of the Securities Exchange Act of 1934, 15 U.S.C. §78t(a), is the statute involved, and is correctly set forth in the Petition.

STATEMENT OF THE CASE

The case involves the duties imposed upon a broker-dealer and its "control persons" to protect public investors from injury inflicted by persons the broker-dealer hires and controls. The decision of the Seventh Circuit applying Section 20(a) of the Securities Exchange Act of 1934 in this case is consistent with the application of Section 20(a) by all circuits. A broker-dealer's control persons are required to exercise stringent supervision

[1] **Citations to Record:** References to the Witter petition for certiorari are (P.___), to the petition's appendices (P.App.___), to Plaintiff-Appellant's Appendix in the Seventh Circuit (App. ___), to the various depositions are John Kenning (K.___), John Carpenter (C.___), Richard Frost (F.___), Hudson T. Harrison (H.___), Alfred Rauschmann (R.___).

over the firm's salespeople. *Lanza v. Drexel & Co.*, 479 F.2d 1277, 1301 (2d Cir. 1973).

Dean Witter Reynolds, Inc. employed John Kenning as a Vice-President. While serving as such Witter Vice-President, Kenning initiated and maintained a massive securities fraud scheme which he conducted from the Witter branch office in Boca Raton, Florida. This fraud duped 125 victims over a period of two and one-half years (January 1984 to July 1986). These 125 people invested the aggregate sum of $7.5 million. (App. 94-95). The plaintiffs[2] were among the last victims taken in by the fraud, Mr. Harrison having been "sold" in March 1985; however, Mr. Harrison sustained the largest loss of any victim, $3,229,000.[3] (App. 87, 94-95).

Kenning told Mr. Harrison, and the 125 other investors that their money was invested at Witter in a specially available municipal bond fund. (P.App. 2). In fact, and unknown to any victims, there was no municipal bond fund, and no municipal bonds were purchased. (K. 70). The concealed truth was that Kenning invested more than one-half of all of the fraudulently obtained funds in purchases of put options against Standard & Poors 100 Index futures contracts ("OEX puts"). These purchases were made in a Witter account in the name of Kenning's 25

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[2] In addition to the parties listed in the caption of the case, Thomas P. Ward was a party to the proceeding in the court whose judgment petitioner seeks to review (See P.App. 21-25). There are no parent companies or subsidiaries of Harrison Construction Incorporated.

[3] Harrison lost $2,166,953, and the corporation lost an additional $1,062,200. (First Am. Comp. 20(a) and (b), 28).

year-old associate, John Carpenter (the "Carpenter Account"). (K. 75-77; C. 34).

Carpenter and Kenning shared the same office in the Witter branch and shared the same book of customer business. (F. 784, K. 247). The share of gross income payable on all business was divided by Witter between the two "partners". (Pl. Ex. 55). The OEX put purchases, made through Witter and cleared in Carpenter's Witter account, were each cleared by the branch manager, Mr. Frost. (F. 654, 672-73). From inception until Kenning and Carpenter notified Witter of their fraud in July 1986, they bought 97,000 put contracts through Witter, upon which the "Carpenter Account" showed a $1,844,000 loss; Witter's gross revenue/income on these transactions was $428,000. (App. 99). Virtually every dollar that passed through the account came from one or more of the 125 victims. (K. 291).

Kenning made all buy-sell decisions on the Carpenter Account, though Witter knew he was not the source of any funds. (C. 198). Kenning had filed for bankruptcy, informed Frost of this (K. 98), and received his discharge in bankruptcy, all while he continued his daily activities as a Witter Vice-President. (F. 764-65, App. 137-143).

Kenning assured the investor-victims that there was no intent to "cheat" Witter out of bond mark-ups. Harrison and the others were all told that low transaction costs were one reason these pool participations produced higher-than-normal profits, but that Witter was willing to forgo mark-ups in this situation to attract and keep large producers such as himself. (Harrison Affidavit, 1/9/89). Kenning's explanation for the high rate of promised

return (which was substantially less than the "18% to 60%" referred to; P. 3), was that Witter's bond traders always selected bond issues they could buy at a price slightly below par within 90 to 180 days of redemption, or of a "call" date. (K. 69-70). Then when the bonds were called, the issuer paid a premium which was added to the accrued tax-free interest.

The two-and-one-half year fraud ended in July 1986 when Kenning and Carpenter resigned. They went to the United States Attorney, pleaded guilty, and received jail sentences (Kenning's was eight years, Carpenter's four). Harrison filed suit in October 1986.

REASONS WRIT SHOULD BE DENIED

I. STANDARD APPLICABLE IN SECTION 20(a) LITIGATION

A plaintiff establishes the element of control under §20(a) by supporting his claim with evidence that (1) the alleged control person actually participated in, that is, exercised control over the operations of the person in general, and (2) the control person had the power or ability to control the specific activity upon which the primary violation was predicated, whether or not the power was exercised. The Seventh Circuit's endorsement of this standard (P.App. 12) is consistent with the standard applied by every circuit. The Seventh Circuit held that the existence of "control", in this situation, is to be determined by the trier of fact applying the above standard. (P.App. 13). Where the fraud perpetrators were registered representatives employed by the broker-dealer

while they were conducting the fraud, a motion for summary judgment by the broker-dealer would fail.

II. NO CONFLICT AMONG THE CIRCUITS EXISTS

Every circuit has expressly or impliedly applied the same standard to determine the question of "control". A defendant is a "controlling person" under §20(a) if it has only some direct means of discipline or influence short of actual direction; there is no requirement that the defendant must have actually participated in the primary violation. *First Interstate Bank of Denver, N.A. v. Pring*, 969 F.2d 891, 896, 897 (10th Cir. 1992); *Metge v. Baehler*, 762 F.2d 621, 631 (8th Cir. 1985). Neither does a control person escape liability on a showing that it had no knowledge of the perpetrator's fraudulent activities. As the court noted in *Donahoe v. Consolidated Operating & Prod. Corp.*, 982 F.2d 1130, 1138 (7th Cir. 1992):

> If the rule were otherwise, [control persons] could escape control liability by remaining as ignorant as possible – surely not the result that Congress intended.

The SEC's definition of control is to the same effect. 17 C.F.R. §230.405 (1992).

Except for a 1978 opinion by the Ninth Circuit, which has since been overruled, all reported cases hold broker-dealers are "control persons" in respect to fraudulent acts

of employees perpetrated while the broker-dealer employed them.[4]

In any broker-dealer situation, the element of "control" is not affected by a claim that the employee-perpetrator was acting for his own purposes, that he was attempting to conceal his fraud from his employer, or that his acts of fraud violated broker-dealer rules.[5] *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564 (9th Cir. 1990), held a broker-dealer subject to §20(a) liability because it registered, though it did not employ, the wrongdoer who was an independent contractor. *Id.* at 1574. Titan asserted that it did not exercise any control over the individual it had registered, and that it knew nothing of his conversion of investors' funds (some checks were made out to him personally at his request, and the broker-dealer did not benefit from the defalcation – an assertion Witter cannot make). Summary judgment was reversed because the Court found a control relationship between Titan and the independent contractor-perpetrator. *Id.*

The Fifth Circuit applied the standard to hold a broker-dealer liable on a claim based on a registered

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[4] See *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1575 (9th Cir. 1990), *cert. denied*, 111 S.Ct 1621 (1991), overruling *Christoffel v. E.F. Hutton & Co., Inc.*, 588 F.2d 665 (9th Cir. 1978).

[5] Those may be elements of the "good faith" defense provided by §20(a), but they cannot be established under the case law of any circuit on a motion for summary judgment. The broker-dealer must, at trial, carry the burden of persuasion that its supervisory system was adequate and that it reasonably discharged its responsibilities under that system. *Hollinger*, 914 F.2d at 1576.

representative secretly conspiring with others to manipulate the price of stock. *Paul F. Newton & Co. v. Texas Commerce Bank*, 630 F.2d 1111, 1119 (5th Cir. 1980).

The same result was reached in the Fourth Circuit where a registered representative induced investors to buy real estate interests from persons having no relationship with his broker-dealer employer by falsely stating the firm handled private financing of such projects. *Hunt v. Miller*, 908 F.2d 1210, 1215 (4th Cir. 1990).

In fact, Witter in its Petition acknowledges that these circuits have applied the "control" standard in a manner consistent with that of the Seventh Circuit in this case. (P. 10).

However, the Petition claims that the Second and Third Circuits require that §20(a) liability be based on something more than mere control. (Pet. 9-10). Petitioner's position is erroneous. In *Rochez Brothers, Inc. v. Rhoades*, 527 F.2d 880 (3d Cir. 1975) on which the petition relies, the Third Circuit expressly recognized that Section 20(a) imposes a more stringent duty on broker-dealers than that under a "culpable participation" standard.

> **This duty is imposed to protect the investing public and make brokers aware of the special responsibility they owe to their customers.**

Id. at 886. Since *Rochez Brothers*, the Third Circuit has twice upheld vicarious liability under the Act without "culpable participation". *See Sharp v. Coopers & Lybrand*, 649 F.2d 175 (3d Cir. 1981), *cert. denied*, 455 U.S. 938

(1982)[6]; *Eisenberg v. Gelrod, Fox & Co.*, 766 F.2d 770, 784 (3d Cir. 1985).

Likewise, the Second Circuit applies a control standard functionally identical to the standard here. *See Marbury Management, Inc. v. Kohn*, 629 F.2d 705, 716 (2d Cir. 1980), cert. denied, 449 U.S. 1011 (1980). In *Marbury Management, Inc.*, control was assumed because of the relationship between the brokerage house and the wrongdoer. Specifically, the brokerage house employed the wrongdoer as a "lawfully licensed registered representative." At 707.

Thus, contrary to Petitioner's position, there is no conflict among the circuits on the "control" standard, and no need for this Court to grant certiorari.

III. THERE IS NO BASIS FOR WITTER'S CLAIM THAT PLAINTIFFS KNEW OR SHOULD HAVE KNOWN THE CONTROLLED PERSONS' CONDUCT WAS UNAUTHORIZED.

Kenning was hired by Witter, and was paid $50,000 front money to join Witter, three months before his first fraudulent representations injured investors. (F. 239-40, 355). Kenning had been conducting the fraud as a Witter

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[6] Coopers & Lybrand's petition for certiorari declared the issue was whether vicarious liability was imposed by the Act " . . . when a jury has found that no partner in defendant accounting firm acted recklessly or with intent to defraud and that it was not foreseeable to defendant that plaintiffs would suffer any injury from defendant's allegedly misleading tax opinion letter?" Docket No. 81-433, quoted in 50 U.S.L.W. 3329 (Oct. 27, 1981).

salesperson for 14 months before he met Harrison, convincing him, as he had convinced over 100 persons before him, that Kenning's apparent authority to solicit investments in securities through Witter included authority to solicit funds needed to complete bond purchases in a Witter program. (H. 491, C. 115-116). Harrison made repeated contact over the period of the fraud by calling Kenning at Witter's Boca Raton branch. (H. 318-322, H. 66).

Witter has again, as it has in every brief and memo filed since this case began, asserted that there is no issue of fact as to what Harrison knew or should have known. To support this assertion, Witter presents as fact matters that Harrison emphatically denies, asks the Court to draw inferences that are contrary to sworn testimony, and asserts that such representations and inferences should support Witter's motion for summary judgment. It was the grant of summary judgment by the district court which the Seventh Circuit Court of Appeals correctly reversed.

When deciding a motion for summary judgment, the district court must treat as true all factual inferences resolved *against* the moving party (Witter) and in favor of the party opposing the motion. Summary judgment is not the appropriate occasion for weighing evidence; at the summary judgment stage, Harrison (as the non-moving party) was entitled to have the credibility of *his* evidence as forecast assumed, his version of all that is in genuine dispute accepted, and all internal conflicts in the evidence resolved favorably to him; *Blanchard v. Peerless Ins. Co.*, 958 F.2d 483, 489 (1st Cir. 1992). *Dowden v. Polymer Raymond, Inc.*, 966 F.2d 1206, 1207 (7th Cir. 1992). Witter

(the moving party) again presents inferences drawn by its attorneys as "facts", but drawing inferences favorable to a moving party is forbidden in ruling on a motion for summary judgment. *Drexel v. Union Prescription Centers, Inc.*, 582 F.2d 781, 789 (3d Cir. 1978).

The facts Harrison presented and the denials he made under oath in his deposition and affidavit demonstrate the investment program was presented to him, and to the other 125 victims, by Vice-President Kenning as a Dean Witter program. Each victim had been told the same story (K. 501), i.e., Witter had a program designed to attract and retain large producers of gross revenue for Witter. (K. 71, H. 491, C. 115-16). The program was said to buy municipal bonds at only 1/16th or 1/8th of a point over the "bid" price, made possible because of the large number of bonds Witter's traders bought in each transaction. (K. 485, 71). There was no Witter mark-up on these bonds by Witter because direct purchase was limited to select "big producers", like Kenning and Carpenter. Under the Witter program, Kenning stated Witter did not prohibit the participants from obtaining funds from outside their own resources to pay for the special program bonds.

Kenning told the investors that Witter financed 70% of the purchase price of these bonds (K. 488), and that Kenning-Carpenter shared the profits they realized with persons who provided some of the cash needed to participate in the Witter program. Each investor was given promissory notes, which assured Harrison (and the others) he would be paid the tax-free gain (the coupon interest on the bonds) which his funds supported; Kenning and Carpenter were to keep the taxable capital gain.

(K. 492). Kenning always represented to Harrison that Kenning's own direct investment was larger than those he shared with the others. (K. 71-72, 88-89, Dep. of 4-18-88).

Harrison furnished investment money on 17 occasions; the aggregate came to over $4.0 million. (P. App. 2). As fictional bonds acquired with these investment funds "matured", Kenning urged Harrison to "roll" his proceeds into a new bond position. (K. 345-46). Usually he did so, but at times Harrison requested the return of some of his capital. Harrison received $800,000 in response to such requests. On several occasions Harrison offered to open accounts at Witter, but Kenning put him off. (K. 489).

IV. BOTH LEGISLATIVE HISTORY AND JUDICIAL INTERPRETATION SUPPORT THE SECTION 20(a) HOLDING.

The 1934 Act includes a savings clause which provides that "[t]he rights and remedies provided by this chapter shall be in addition to all other rights and remedies that may exist in law or in equity." 15 U.S.C. §78bb(a). Respected scholars have concluded:

> These savings clauses are eloquent testimony to the absence of any intent to preempt common law secondary liability. Quite the contrary these provisions were aimed at *extending* liability.

9 Loss & Seligman, *Securities Regulation*, 4477 (1992).

There is no disagreement among the circuits respecting the legislative purpose of §20(a). Congress intended

to protect the investor in a highly sophisticated field. *Hecht v. Harris Upham & Co.*, 430 F.2d 1202, 1207 (9th Cir. 1970). Contrary to Witter's assertion, the courts recognize that Congress incorporated agency principles into §20(a) to *expand* the scope of liability in order to hold broker-dealers responsible for the acts of their employees. *SEC v. Management Dynamics, Inc.*, 515 F.2d 801, 812-13 (2d Cir. 1975). The statute was intended to supplement, and not to supplant, common law theory as a basis for vicarious liability in securities cases. *Hollinger*, 914 F.2d at 1576-77.

All circuits now agree with the analysis of legislative history and intent incorporated in *Paul F. Newton & Co.*, 630 F.2d at 1118-19. The remedial purpose of the federal securities acts requires a brokerage firm that provides an employee with the means to carry out fraudulent practices to pay damages unless it can sustain the burden of proving the "good faith" defense to the trier of fact. The rights provided victims of such fraud under the common law of agency and under §20(a) were intended by Congress to be, and they are, cumulative. *Id.* at 1118. At the time *Paul F. Newton & Co.* was published, the Third Circuit and the Ninth appear to have interpreted §20(a) less broadly, but both have since conformed. *See Hollinger*, 914 F.2d 1564; *Sharp* 649 F.2d 175 (agreeing that the securities laws expanded the scope of vicarious liability, but that it should not be widely expanded).

V. THERE IS NO CONFLICT WITH ALL (OR ANY) OTHER INTERPRETATIONS OF SECTION 20(a).

Witter's assertion that there is a conflict between the Seventh Circuit's §20(a) standard "and all prior interpretations" is baseless. (Pet. 14-15). Further, the assertion rests on a claim that is worse than baseless in that it is contradicted everywhere in the record. The thoroughly discredited claim is that "Witter had and undisputedly enforced" a system that would have insured that Harrison and the other 125 victims ("any reasonable non-customer") understood Witter had not authorized the Kenning-promoted transactions. What is undisputed is that none of the 125 *did so understand.*

Without registration by a broker-dealer, Kenning could not possibly perpetrate this type of fraud. What kind of a supervisory system is required to prevent frauds by persons who, but for their registration by the control person, would be unable to perpetrate such frauds? One answer would be a system that would vigorously inquire into how a 25-year old registered representative (Carpenter), through whose Witter account millions of dollars passed, was able to make same-day settlement on the purchase of 97,000 OEX put contracts over 30 months, and was able to pay Witter realized losses of $1,844,000. The system would contemplate close questioning of a registered employee who was realizing such losses when his branch manager (and numerous people in Witter's compliance department) knew he had failed in the quest that brought him from Illinois to Florida (i.e., to become a PGA Tour golfer), and had never held a job before joining Witter (September 1983) that paid more

than $5.00 per hour. (F.Ex. 83; C. 12, 17). The system would also require vigilance by the Director of Compliance, whose staff had fired off seven wires to the Boca Raton branch manager over eleven months in 1984 pointing out a "significant number of options" being purchased in the Carpenter account. (Pl. App. 179-186). Nothing was done by the branch manager. Vigorous enforcement would require more from the Director of Compliance than his expressed conclusion that on this record the branch manager was doing a superb supervisory job. (R. 148). The branch manager believed that nothing in the Carpenter account history required managerial concern because, "[Carpenter] was paying with good money. I had no reason to disbelieve anything." (F. 746).

On the facts that came before the branch manager every day and those that were regularly presented to higher levels of management throughout the period of Witter's control, the question is whether the control person took adequate precautionary measures to prevent injury caused by an employee, whether it supervised the fraud perpetrators in an adequate and reasonable fashion and whether it diligently maintained and diligently implemented its system of control. *Hunt v. Miller*, 908 F.2d at 1215. There is nothing in the Seventh Circuit's opinion that implies Witter must tap and continuously monitor all employee telephone conversations, verify the source of *all* funds, etc. as paraded in Witter's Petition. (P. 15). However, to establish the "good faith" defense, a trier of fact may well expect a broker-dealer to have vigorously inquired into the source of the nearly $3 million deposited by young Mr. Carpenter, and into how the Kenning-

Carpenter team obtained funds to settle losses over 30 months of nearly $2 million when one claimed a net worth of $25,000 and the other was going through bankruptcy. The refusal by the Seventh Circuit to affirm summary judgment on these facts is anything but dramatic, and it certainly is not singular.

CONCLUSION

There is no conflict between the circuits respecting the standard of control required of broker-dealers in respect to their registered employees under §20(a). The Seventh Circuit decided this issue in a manner that comports with both Congressional intent and consistent judicial interpretation of the statute. For these reasons, the petition for a writ of certiorari should be denied.

Respectfully submitted this 29th day of April, 1993.

Respectfully submitted,

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Supreme Court, U.S.
FILED
JUN 2 1993
OFFICE OF THE CLERK

(3)

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Petition for Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

PETITIONER'S REPLY BRIEF

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Petition for Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

PETITIONER'S REPLY BRIEF

REASONS FOR GRANTING THE WRIT

I. INTRODUCTION

As demonstrated in Dean Witter's[1] Petition, the law of Section 20(a) is in a terribly confused and contradictory state. Respondent Harrison relies on this confusion to obscure this Petition's principal issue, which is—whether an employer may be vicariously liable under Section 20(a) when it *is not* liable under common law agency, respondeat superior *or* negligence principles. Thus, by blatantly mischaracterizing the relevant authority, Harrison attempts to recast the consensus in favor of the converse proposition (i.e., that common law vicarious liability principles supplement Section 20(a) in securities law cases) as support for the holding in this case.

Here, the Seventh Circuit held that a broker-dealer bears the burden of proving a negative (non-negligence in any aspect of its supervision) if it is to escape *vicarious* liability under Section 20(a) for violations of Section 10(b) committed by an employee in personal transactions with *non-customers* that, as a matter of law, fell well (and transparently) *outside* the scope of *the employee's actual, implied, ostensible, and apparent authority.* This decision completely ignores all recognized principles of vicarious liability in favor of creating what amounts to an incredibly broad, negligence cause of action against broker-dealers for failing to supervise non-violative activity in employee accounts so as to insure the protection of unknown *non-customers* in their unknown and obviously unauthorized personal dealings with employees. By premising a broker-dealer's potential vicarious liability under Section 20(a) on

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[1] Petitioner Dean Witter Reynolds Inc. is a subsidiary of Sears Roebuck & Company.

its supervision of activity that neither violated the securities laws nor proximately caused plaintiff's injuries, the Seventh Circuit abolished any requirement that there be some nexus between the broker-dealer's "control" and the conduct for which it is to be held accountable as a "controlling person". Contrary to Harrison's arguments, this construction of Section 20(a) cannot be reconciled with its language, its legislative history, the 1934 Act's overall scheme or the law of any other circuit.

II. CONTRARY TO THE LANGUAGE AND LEGISLATIVE HISTORY OF SECTION 20(a), THE SEVENTH CIRCUIT'S HOLDING MAKES BROKER-DEALERS INSURERS OF THEIR EMPLOYEES' CONDUCT

Harrison argues that holding a broker-dealer vicariously liable for employee acts of which it was unaware, in which it did not participate, *and* that it neither actually nor apparently authorized is consistent with the legislative history of Section 20(a) and the statutory scheme of which it is part. To support this argument, Harrison cites only the "savings clause" and the "remedial purpose" of the Securities Exchange Act of 1934.[2] Harrison's reliance on the Act's savings clause and remedial purpose is completely misplaced.

The savings clause may be relevant in deciding whether agency principles supplement Section 20(a) as a basis for vicarious liability under the Act. The savings clause, however, sheds absolutely no light on the issue presented here—whether a broker-dealer's Section 20(a) "control" extends to conduct that it neither actually nor apparently authorized.

Second, as stated by this Court, "[t]he invocation of the 'remedial purposes' of the 1934 Act . . . will not justify

[2] Respondents' Brief in Opposition ("R.B.") at 12-13.

reading a provision 'more broadly than its language and the statutory scheme reasonably permit.' "[3] Thus, the Act's remedial purpose also does not evidence any intent by Congress to expand an employer's (even a broker-dealer's) liability for employee acts beyond the strict liability provided for by common law.[4]

Finally, while Harrison notes that all courts agree concerning the legislative history of Section 20(a), he completely ignores the most compelling aspect of that history—Congress' *collective* rejection of an insurer's standard of liability in favor of a fiduciary "good faith" standard.[5] Congress' express rejection of the insurer's standard proposed by the Senate strongly evidences an intent to limit liability under Section 20(a) to situations involving culpable conduct. Indeed, this Court has expressly recognized that Section 20(a) incorporates a state-of-mind condition that requires a showing of *something more than negligence* to establish liability.[6]

By requiring broker-dealers to prove non-negligence to escape Section 20(a) liability, the Seventh Circuit's holding not only makes broker-dealers the insurer's of their employees' conduct (*personal* as well as job-related) but also relieves plaintiffs of the burden of establishing *even* negligence (much less something more). Such a result is entirely inconsistent with the language and legislative history of Section 20(a)—a statute that was intended to extend

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[3] *Touche Ross & Co. v. Redington*, 442 U.S. 560, 578 (1979) (cite omitted).

[4] *See Hollinger v. Titan Capitol Corp.*, 914 F.2d 1564, 1579-83 (9th Cir. 1990) (Hall, J. dissenting), *cert. denied*, 111 S.Ct. 1621 (1991).

[5] *See, e.g., Paul F. Newton & Co. v. Texas Commerce Bank*, 630 F.2d 1111, 1116 (5th Cir. 1980).

[6] *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, nn. 27-28 (1976).

accountability to those who "control" violative conduct through power relationships other than employer/employee or principal/agent, not to expand an employer/principal's already strict liability for employee/agent conduct.[7]

III. THE SEVENTH CIRCUIT'S HOLDING IS DIRECTLY AT ODDS WITH THE LAW OF OTHER CIRCUITS AND IN ACCORD WITH THE LAW OF NO OTHER

The Petition demonstrates that no other court has ever extended a control person's liability under Section 20(a) to conduct for which an employer or principal could not be held liable at common law. Harrison's contrary argument, that the Seventh Circuit's holding is not in conflict with the law of other circuits, rests entirely upon gross mischaracterizations of the relevant authority.

For example, citing *Sharp v. Coopers & Lybrand*[8] and *Eisenberg v. Gagnon*,[9] Harrison asserts that the Third Circuit has "twice upheld vicarious liability *under the Act* without 'culpable participation'."[10] This assertion is entirely false. *Eisenberg* involved neither a Section 20(a) claim nor any issue concerning respondeat superior's role under the securities laws,[11] but simply affirmed a finding of respondeat superior liability under state law.[12] Similarly, *Sharp* did not reject, *but expressly reaffirmed*, a "culpable participation" standard for Section 20(a) liabil-

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[7] *E.g., In re Atlantic Financial Management, Inc.*, 784 F.2d 29, 33 (1st Cir. 1986), *cert. denied*, 481 U.S. 1072 (1987).

[8] 649 F.2d 175 (3d Cir. 1981), *cert. denied*, 455 U.S. 938 (1982).

[9] 766 F.2d 770 (3d Cir. 1985) (cited by Harrison as *Eisenberg v. Gelrod, Fox & Co.*).

[10] R.B. at 8-9 (emphasis supplied).

[11] 766 F.2d at 783 n.7.

[12] *Id.* at 783-784.

ity.[13] Although, the *Sharp* court went on to find that the error in failing to instruct the jury accordingly was harmless by holding that the Third Circuit's general rule that Section 20(a) preempts respondeat superior liability was not applicable where the accounting firm defendant had authorized that the tax opinion involved be issued in the firm's name.[14]

Harrison also misrepresents the law of the Second Circuit. Contrary to Harrison's assertion, *Marbury Management, Inc. v. Kohn*[15] does not even discuss a "control" standard, much less apply one that is either "functionally equivalent" to the one applied here or inconsistent with the "culpable participation" standard adopted by the Second Circuit in *Lanza v. Drexel & Co.*[16] As in *Sharp*, the principal issue decided in *Marbury* was that respondeat superior can provide an alternative basis for vicarious liability under the securities laws.[17]

Harrison also argues that *Hunt v. Miller*[18] demonstrates that the decision in this case is consistent with the law of the Fourth Circuit. Like *Marbury*, however, *Hunt* simply discusses what must be shown under Section 20(a) once "control" is established, not what must be shown to establish control.[19] More importantly, *Hunt* treats a lack of diligent supervision as evidence of the "culpable participation" that a plaintiff must prove to establish Section 20(a)

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[13] 649 F.2d at 185.

[14] *Id.* at 185-87.

[15] 629 F.2d 705 (2d Cir.), *cert. denied*, 449 U.S. 1011 (1980).

[16] 479 F.2d 1277 (2d Cir. 1973) (en banc).

[17] 629 F.2d at 712-15.

[18] 908 F.2d 1210 (4th Cir. 1990).

[19] *Id.* at 1215.

liability under Fourth Circuit law.[20] Requiring proof of culpability (bad faith) as part of a plaintiff's *prima facie* case is, of course, directly at odds with the Seventh Circuit's decision that the broker-dealer defendant must prove its good faith—even with respect to employee conduct that, as a matter of law, was strictly personal.

Finally, Harrison relies on the Ninth Circuit's decision in *Hollinger v. Titan Capital Corp.*[21] But, as the Petition points out, *Hollinger* does not allow for Section 20(a) liability where (as here) the "representative was acting outside of the broker-dealer's statutory 'control' . . . [because plaintiffs] were not *reasonably relying* upon him as a registered representative of [the broker-dealer]. . . ."[22] Accordingly, in a decision issued the day after the Petition was filed, on strikingly similar (but less egregious) facts, a broker-dealer was held not liable under Section 20(a) because the non-customer who entered into transactions that were neither actually nor apparently authorized "was not reasonably relying on [the employee] as a registered representative of [the broker-dealer]."[23] Another result that is directly contrary to the decision in this case.

The extent to which Harrison is forced to mischaracterize the cases he cites demonstrates just how out-of-step the holding at issue is. In effect, the Seventh Circuit inter-

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[20] *Id.*; *see also Carpenter v. Harris Upham & Co., Inc.*, 594 F.2d 388, 395 (4th Cir.), *cert. denied*, 444 U.S. 868 (1979) (under Section 20(a), broker-dealer's "bad faith" is an element of plaintiff's *prima facie* case).

[21] 914 F.2d 1564 (9th Cir. 1990) (en banc), *cert. denied*, 111 S.Ct. 1621 (1991).

[22] *Id.* at 1575-76 n.26 (emphasis supplied).

[23] *Kohn v. Optik, Inc.*, [Current Developments] Fed. Sec. L. Rep. (CCH) ¶97,435 at 96,418-421 (March 30, 1993).

preted Section 20(a), a vicarious liability statute, as implying a direct cause of action against broker-dealers for negligent supervision—a cause of action in which the broker-dealer bears the burden of proving non-negligence and in which the plaintiff (to whom the broker-dealer owes no common law duty of care) need not even establish a nexus between the broker-dealer's "control" and the securities law violations at issue. Such a result is simply not in accord with the law of any other circuit, regardless of the particular variation of control standard applied.

IV. HARRISON'S FACTUAL ARGUMENTS ARE IRRELEVANT TO THE PRINCIPAL ISSUE INVOLVED—WHETHER A BROKER-DEALER'S "CONTROL" UNDER SECTION 20(a) EXTENDS TO CONDUCT FOR WHICH EMPLOYERS CANNOT BE HELD RESPONSIBLE AT COMMON LAW—AND ALSO TO THE SECONDARY ISSUE, UNLESS NEGLIGENCE (AND NOTHING MORE) IS SUFFICIENT TO NEGATE SECTION 20(a)'S GOOD FAITH DEFENSE

In opposing the Petition, Harrison raises factual arguments concerning the adequacy of Dean Witter's supervision of certain activity in one of its employee's personal trading accounts—activity that neither constituted securities law violations nor proximately caused Harrison's injuries. In particular, Harrison argues that Dean Witter might have been more diligent in investigating the employee's source for the approximately $1.8 million[24] that

[24] It is not disputed that the primary source for these funds was the approximately $7.5 million the employees successfully persuaded Harrison and other non-customers to loan to them, *personally*, by misrepresenting that the funds would be used to buy municipal bonds in their personal accounts at steep discounts, available only to employees, that would allow the employees to "guarantee" exceptionally large returns to the non-customer lenders (5 to 10% in 30 to 180 days or 18 to 60% on an annualized basis).

he lost trading options in his own account. These factual arguments, however, are just as irrelevant to the Petition's first (and principal) question as they are to the common law issues of apparent authority and duty.

In affirming summary judgment on all but one of the multiple federal and state law claims asserted by Harrison, the Seventh Circuit held that, as matters of law:

1. Dean Witter had no common law duty to protect Harrison from the intentional torts of its employees because Harrison: a) was never a Dean Witter customer; and b) was not injured on Dean Witter's premises or through the use of Dean Witter property; and,
2. Harrison could have protected himself more easily than Dean Witter could have detected and prevented the fraud because any reasonable person would have understood that the employees' offer to share the benefit of their employee discounts was well outside the scope of their authority.[25]

The principal question presented by this Petition is whether, despite these rulings, Dean Witter still may be

[25] Harrison, of course, does not agree with the apparent authority ruling and has filed a Cross-Petition seeking its review. Indeed, Harrison's discontent with this ruling evidences itself throughout his brief in opposition, i.e., the disingenuous attempts to equate the consensus concerning respondeat superior's role in securities law cases to the holding at issue and the claim that the holding (styled "Dean Witter's claim") that any reasonable person would have understood that the transactions at issue were unauthorized "is contradicted everywhere in the record." R.B. at 14. Dean Witter will address the fallacies of Harrison's position in its Brief in Opposition to the Cross-Petition. The questions presented by this Petition, however, assume (as did the relevant holdings) that, as a matter of good law, Dean Witter neither actually nor apparently authorized its employees' personal loan transactions with Harrison.

held accountable to Harrison under Section 20(a) or, in other words, whether a broker-dealer may be deemed to "control" an employee's unknown personal transactions with strangers that the broker-dealer did absolutely nothing to facilitate or to (even implicitly) indicate were authorized. Only if this question is answered affirmatively—a result that would be inconsistent with the language, the legislative history, and all other judicial interpretations of Section 20(a)—does any issue arise concerning Dean Witter's supervision of its employees.

Second, it is undisputed that Dean Witter had and diligently enforced supervisory procedures that required its branch manager to review every piece of incoming and outgoing correspondence and to intercept all incoming checks. It is also undisputed that these procedures were purposefully evaded, to conceal the transactions, by having Harrison send his checks and wire transfers (all $4 million payable to the employee personally) to the employee's home or personal bank account. In light of these *undisputed facts*, any failure on Dean Witter's part to discover that money lost in the employee's personal account had been fraudulently obtained in private transactions with non-customers amounts to *no more than* negligence. Thus, the second question presented is whether a broker-dealer may be deemed to have acted in bad faith for simple negligence or whether something more is required. If something more than negligence is required under Section 20(a), as this Court has stated, then the Seventh Circuit's construction of that statute constitutes a serious

error and this Petition should be granted with respect to the second, as well as the first, question presented.

Respectfully submitted,

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